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Certified Public Accountant

THE STATE SOCIETY'S 60TH YEAR

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The matters contained in this publication, unless otherwise stated, are the statements and opinions of the authors of the articles, and are not promulgations by the Society.

Accounting News And Trends

Opening Inventories and Observation of Physical Count

Is a CPA required to disclose the fact that he did not observe the taking of the inventory at the beginning of the fiscal year on which he is reporting? Should such a CPA take an exception to the results of operations for the year under review? *The Michigan CPA* (September, 1957) sets forth the answers of the Michigan Society's Committee on Accounting Principles and Auditing Procedures.

According to this Committee, the CPA is not required to disclose his failure to observe the taking of the prior year's closing inventory, but he must satisfy himself as to such inventories by appropriate methods. Four members of the Committee, however, disagreed with the majority and stated that disclosure should be made of the failure to observe the prior inventory.

As to the second question, all except one member agreed that the CPA is not required to take exception to the results of operations for the year under review if he satisfied himself by appropriate methods that the opening inventory was stated fairly. The procedures necessary in this respect would depend upon the circumstances, but should include an investigation resulting in reasonable assurance that a reliable physical inven-

tory was taken and should include the usual tests of prices, extensions, cut-off, inactive items, etc.

Bank Directors' Duties

A new booklet entitled "The Bank Directors' Responsibility: A High Public Service" has recently been issued by the New York State Banking Department. The book discusses in general terms the duties and obligations of a director and also contains a fifty-page compendium of law excerpts affecting bank directors.

The booklet points out that the director should insist upon full disclosure to the board by management of all major business affairs of the institution. In this connection, it warns the director not to place too great a reliance on executive officers lest he be put in the position of becoming a rubber stamp for officers' decisions.

CPAs will find of particular interest a listing of the major responsibilities of a director because it is suggested that perhaps his most important duty is the provision for internal and, when necessary, external examinations and audits by independent public accountants.

Industry Ratios

Continuing its new policy, inaugurated last year, of making its material available to the interested public, Robert Morris Associates has recently issued its *1956 Statement Studies*. This year the "basic study" section contains financial information on 156 lines of business—13 more than in 1955. The "income supplement" portion contains additional information on selling and delivery expense, officers' salaries, and general administration expenses for some 127 lines of business.

ACCOUNTING NEWS AND TRENDS is conducted by CHARLES L. SAVAGE, C.P.A. and member of the New York Bar. He is presently serving as chairman of our Society's Committee on Members in the Field of Education.

Dr. Savage is professor of accounting and chairman of the Business Administration Division of St. Francis College.



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Nearly 500 banks cooperated in gathering information from 10,642 individual companies. These companies are grouped into 156 lines of business and each line is subdivided into groups by total asset size—under \$250,000, \$250,000 to \$1 million, and \$1 million to \$10 million. The statements are common-size composite financial statements expressed in percentages with a group of ratios setting forth the averages for manufacturing, wholesaling and retailing lines of business.

These studies will undoubtedly be of great value to CPAs in their analysis of clients' financial statements. Copies can be obtained at a cost of \$10.00 each from the Robert Morris Associates, National Bank Building, Philadelphia 7, Penna.

Reporting on Adequacy of the Client's Records

In his article "Business Organization And The Public Accountant" in *The Accountant* (England) Sept. 28, 1957, Mr. J. E. Harris makes some interesting comments on the accountant and management services. The article discusses two main topics—the extent to which the internal organization of a business affects the certificate given by the public accountant in his capacity as auditor and whether it is practicable for an audit to include an evaluation of the efficiency of the company's organization.

Under British law the auditor is required to report on the adequacy of the firm's books and must take an exception in his report if the books are deemed inadequate. In pursuing this aspect of his audit, it would be most appropriate for the auditor to advise the client as to what is the least efficient part of the organization and to suggest changes that will enable the accountant to issue an unqualified certificate. But, except for these suggestions which grow out of the statutory duty of the auditor, the author believes the auditor should make no efforts to appraise the overall

efficiency of a company. He points out that "it [is] vital to maintain as a separate and distinct function the work of the public accountant in his capacity as auditor from work which is either voluntary on his part or requested of him in extension of that necessitated by the audit."

Mr. Harris is not opposed to the accountant's rendering management services, but insists that such activities should be entirely distinct from audit work.

How to Improve Your Writing Skill

Specific suggestions on how you can improve your skill in technical writing are made by A. C. Littleton in "Do-It-Yourself Writing" (Illinois Certified Public Accountant, Summer, 1957). To overcome the oft-lamented "deficiency" in accountants' written communications, you should secure a few simple tools and use them in accordance with a definite program.

The tools recommended are simple—a small book on common errors in English grammar, another on words often misspelled and mispronounced, and a recent dictionary of synonyms. The latter is suggested because good writing is influenced by the choice of the most appropriate word and it is helpful to study the distinctions between words of nearly similar meaning. A strong, flexible, and precise vocabulary is more to be feared than one which is large or fancy.

The program requires the application of these tools in reading and writing. The reading should not be casual and the material should be selected on the basis of excellence of presentation. They may be drawn from a few authors famous for precise writing and from the current literature of accountancy. A few samples should be studied repeatedly and analytically, not in order to copy the style, but to grow in the

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capacity to examine sentences and paragraphs critically whenever you review what you have written in draft form. Note particularly how another's paragraph makes its point and practice asking how your paragraph makes its point.

The most important part of a do-it-yourself program is practice in writing. Start with paragraphs. At first they should be about separate small points of usage or theory and not paragraphs needed for audit reports. Practice in writing paragraphs, in reading them analytically for structure, in rewriting them in varying phraseology—these are the keys to effective writing. Like other skills, the art of effective communication has to be studied and practiced persistently; passive wishing will not suffice.

Competitive Bidding

Competitive bidding for professional engagements was prohibited by the North Carolina Society of CPAs as of July 1, 1957, as was pointed out previously in this Department (July, 1957). In this connection it is interesting to note that such a rule has been effective in Texas since 1946 and the Texas Society of CPAs has prepared a leaflet summarizing its present status.

The leaflet reasserts the prohibition and discusses the question raised by the fact that certain provisions of the state or local laws provide that services of accountants must be obtained by competitive bidding. In the two cases in which this question was ruled upon by the courts, the decisions were that professional services should not be secured by a governmental agency upon the basis of competitive bids, in spite of any statutory, charter, or ordinance provisions. One case involved the employment of an accountant by a municipality wherein the County refused to pay for the services rendered upon the grounds that the contract was void and

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unenforceable because it was not entered into after competitive bids. The Court said: "Contracts by municipalities for services requiring special skill or technical learning are not controlled by statutes requiring the letting of such contract by competitive bids."

Whole-Dollar Accounting

One method of increasing the productivity of the accounting department is by the use of whole-dollar accounting—the recording of accounting entries without the decimal point and pennies wherever possible and at the earliest practicable moment in the accounting sequence. A book entitled *Whole-Dollar Accounting* has recently been published by the Controllershship Foundation, Inc. and presents a comprehensive picture of the problem.

The first chapter in this book is a 42-page analysis of the entire problem. It is followed by detailed reports of 13 carefully selected companies using whole-dollar accounting and four appendices supplying materials which are directly pertinent to the subject.

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The opinion of the researchers is unanimously in favor of whole-dollar accounting. All companies involved reported savings and increased efficiencies. Some examples are: Time Incorporated stated that the time required for payroll summarization and distribution was cut from two clerk-weeks to two clerk-days each month; F. & R. Lazarus Co. estimated the elimination of at least 100,000 digits a month from processing and re-processing in the Sales Audit Department; a medium-sized food manufacturing company stated that reports were in the hands of management and supervisors in a significantly shorter time. The report points out that the most careful investigation "has failed to produce any experience of basic weaknesses or disadvantages inherent in the whole-dollar accounting idea."

The two usual objections to whole-dollar accounting—that it will result in a loss of control and will encourage carelessness and inaccuracies—never actually arose. As the plan works out complete control is still maintained and proper introduction of the system usually results in improved employee morale.

A summary of a controlled test conducted by one of the Companies examined may be of interest. A group of clerks were timed in posting and proving totals with exact pennies and with rounded-off numbers. The rounding formula used was:

Amounts of 51 cents and over—rounded upward.

Amounts of 49 cents and under—rounded downward.

Amounts of 50 cents—rounded to the nearest even dollar.

The results show a saving of 60 per cent spent in time posting, and 43 per cent in checking totals, with a combined saving in time of 50 per cent. In these days of increasing cost pressures, particularly office costs, possibilities of cost reduction are worthy of serious consideration and this report should therefore be reviewed with special interest.

An Adirondack View

Decision Making has always been a problem in business management. Also in home management, wooing a woman, building a bridge, auditing an account—and you can easily add to the list. There are many methods in current use.

One is snapping up a coin. But this allows only two possible answers—coins have little chance of standing on edge. Barnum was wrong about a fool being born every minute—there are two or more. The idea that there are two sides to every question is also in error, and is very deceptive—there are at least three, and often more—as illustrated by the blind men and the elephant.

We who audit have to decide on tests and samples. Recently, much has been written and said about statistical science being used in these decisions. Part of it boils down to using absolute chance in choosing a digit or a decimal number—binary numbers are not too common, yet. So, the problem is, to find something with ten equal possibilities. A card with a spinning hand would do, but it is unhandy to carry, its use is very obvious, and it can easily stop on a line. A roulette wheel is too big, or too breakable if enclosed with a glass face—and it has more twos than it has sevens—I think, but am probably getting out of my (and your) field of experience.

But we have the answer—a new gimmick for some entrepreneur to make a fortune on—dice with ten sides instead of six, numbered 0 thru 9. One or two can be easily carried in your pocket—a mark of distinction.

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Letters to the Editor

Opportunities for Women Accountants

In the auditing agency to which I am attached (N. Y. State Department of Audit and Control), we have an annual recruitment program. There are, however, very few qualified women among the new appointees. I am wondering if you or your readers could enlighten me as to why this situation exists in a field where women possess so many of the qualifications which would equip them for a successful and satisfying career.

This is what actually happens each year:

About this time each year the government agencies have an influx of new, untried Junior Accountants. Most of these career people are recruited from the various colleges offering courses in business administration, with an accounting or economics major. The recruitment takes place in the form of a series of professional examinations given to the students who are in their senior year. The successful candidates of these examinations are interviewed, usually before graduation time, and have the jobs awaiting them after graduation. A small portion of the entrants, however, consist of graduates of former years who, having had their initial experience with firms of public accountants or with industrial firms, want to try their hands at governmental accounting.

It is my pleasant duty to welcome these recruits to their first assignment in government service in the branch to which I am attached. Each year I look for women accountants among these

recruits, and each year I am disappointed. Why it is that they are not attracted to this well-paid, interesting service is beyond me. The reasons may be that having had their accounting courses from instructors who sometimes are engaged in the public accounting field, or associated with large industrial firms, but almost never in government service, they believe that experience can be accumulated only in public accounting or in industry. This, however, is not true. I have been associated with one of the largest auditing agencies in the world, governmental in nature, and have found the association more interesting, more challenging, and more satisfactory with every passing year.

In our work, a Junior Accountant assigned to a particular examination might well see the accounting for and auditing of a food administration agency, a retail gift shop, or a book store. In addition, that junior might be called upon to verify the inventory of and the transactions taking place in a central storehouse, the size of which could be comparable to a good-size super market. Further, our junior might be required to verify the transactions of a cash fund for specified persons, the scope of which would approximate the transactions of a small bank. On rare occasions our junior would be required to account for the tolls received from a bridge or a toll road. He might be concerned with the verifications of revenues from a revenue-producing contract which called for a percentage of the gross revenue of the facility. Then again, he might be con-

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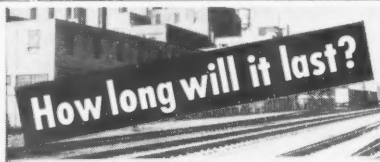
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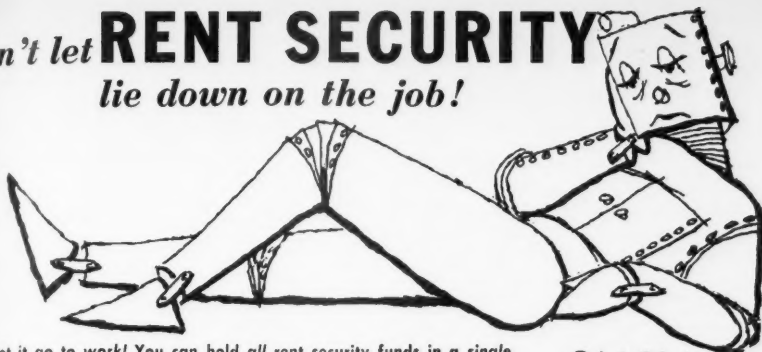
If our junior were attached to a tax
collection agency, he might be auditing
a corporate or a personal income tax
return with the agency point of view
in mind rather than the taxpayer's.
Further, the tax return may have been
prepared by one of his associates of
college days. Then, too, if attached to
still another auditing branch he might
be examining the accounting records of
municipalities or school districts. He
would "go to college", be "admitted to
hospitals", and, heaven forbid, be "con-
signed to correctional institutions". Is
not all this very interesting?

In the course of carrying out his
assignments, he would visit many cities,
and in some instances some of the most
beautiful rural sections of this country.
He would travel in heat and in cold, but
there would never be a dull moment.

In accomplishing all of this travel,
our junior would very often come in
contact with key personnel of industry
or of public accounting firms. These
officials often are on the lookout for
accountants whose experience covers the
governmental branch of accounting. In
my experience I have seen promising
juniors leave the field of governmental
accounting to take more lucrative posi-
tions in industry, but I also have seen
their brother accountants compete in
and pass promotional examinations that
placed them in the grade of senior audi-
tors in a very short space of time.

The only accounting problems with
which our junior might seldom come in
contact would be the balance sheet and
the accompanying statements of opera-
tions. An analysis of surplus, too, is
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The broad and almost limitless horizons of governmental accounting have not apparently appealed to the graduates of business administration courses of our colleges, or to their sisters who have acquired their original experience in industry or public accounting. Something should be done about this lack of interest. I believe it should be brought to the attention of auditors of feminine persuasion that governmental accounting is an interesting, challenging field.

HELEN J. JORDAN
Albany, New York

EDITOR'S NOTE: Miss Jordan is Associate State Accounts Auditor with the Department of Audit and Control, State of New York.

An Argument for the Natural Business Year

A recent release of the American Heart Association contains the headline caption, "Tax Deadlines Seen as Stress on Accountants' Heart and Blood Vessels." The following is a quotation from the release:

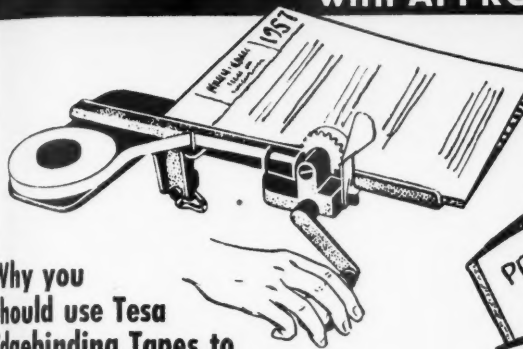
"Your tax return may be even harder on your accountant than on you. At least it may be harder on his heart. . . . As Drs. Rosenman and Friedman described their study, blood cholesterol levels and blood clotting time were determined in each accountant subject every two months from January to June 1957. During this period, severe work stress imposed by the three tax deadlines (Jan. 1-15, March 1-15, April 1-15) alternated with marked lulls in activity. In 83 percent of the entire group, highest blood cholesterol levels were found at the times of greatest work stress; conversely, in three out of four subjects, lowest cholesterol was found at the time of least stress."

The readers of *The New York Certified Public Accountant* may wish to utilize this information in a variety of ways: to increase the sympathy of clients; as an argument for the natural business year; or to justify a Florida vacation during the period January 1-April 15.

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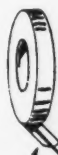
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Regulatory Legislation

Our Society is about to embark upon a vigorous program sponsoring legislation regulating the entire profession of accounting. This is not a radical move. New York State, which passed the first C.P.A. law sixty years ago, and whose present legislation ranks among the most progressive in its educational requirements and ethical standards, has fallen behind so far as regulation is involved. Of the fifty-three jurisdictions which have C.P.A. laws, twenty-eight have regulatory laws. New York is one of the twenty-five with so-called "permissive" laws which do no more than limit the use of the title C.P.A., but are otherwise completely unrestrictive. In this state a C.P.A. who has breached the Rules of Professional Conduct promulgated by the Council on Accountancy is subject to discipline, but a non-C.P.A. is free to violate these rules without penalty.

There is a strong trend toward regulatory legislation. At its meeting in September, 1956, the Council of the American Institute of Certified Public Accountants abandoned its neutral position in favor of regulatory legislation and issued a form bill many of the provisions of which appear in the bill which we shall sponsor. Last fall our own members voted 88% to 12% in favor of such legislation, and non-member C.P.A.s of this state who were also polled voted in favor 80% to 20%.

In enlisting the support of every member of the Society and, in fact, every New York C.P.A., I wish to establish three essential points upon which our program rests:

1. The growth of any profession depends in large measure upon high ethical standards for all. Implicit in this statement is the need for regulation.
2. The proponents of regulatory legislation look forward to the time when there will be only one type of accountant serving the public—the Certified Public Accountant.
3. The enactment of such legislation does not mean the end of our efforts. We shall have to exercise great vigilance as have the

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other states with regulatory legislation in resisting efforts of pressure groups to reopen the closed class of public accountants or to become C.P.A.s by waiver.

The Society's last attempt to secure such legislation in 1951 failed, I have been told, because of lack of "grass roots" support. Let us not make the same mistake again. Your officers have already taken long strides. We have secured the consent of Assemblyman Malcolm Wilson, who was instrumental in securing the repeal of the Oliver Bill and the passage of the Wilson-Brydges Act of 1952, and of Senator Wheeler Milmoë, another good friend of our Society, to sponsor our bill in the next Legislature. We have made clear our aims to the Board of Regents and members of the State Education Department. We have consulted with representatives of The Empire State Association of Public Accountants and the Accountants Association of New York, Inc. and have secured their support. We have progressed on many fronts. But, we shall need the help of every member as well.

There is being mailed to each member a questionnaire inquiring as to which State and federal legislators he is acquainted with and how well. It is essential that we establish in our office an up-to-date roster of members upon whom we may call not only in connection with our regulatory legislation program but in the event of our support of other State or federal legislation. Please return the questionnaire at once and let us know just how well you know your legislators.

We shall call upon specific members to communicate with legislators they know to enlist the support of the latter when our bill is before them. As our program gathers momentum we shall call upon all members to communicate with their legislators so that the strength of our numbers may be felt. We shall ask members to have their clients who are sympathetic with our objective also communicate with the Legislature. And we shall ask chapter officers to solicit the support of other professional groups in the chapter areas.

In the belief that what we seek is in the interests of both the public and the profession, we shall leave no stone unturned to gain that objective. However, we cannot be sure of success without the combined efforts of all. We earnestly solicit the fullest cooperation of the entire membership.

LEONARD PRICE,
President

Education for the CPA

By FRANK P. SMITH

The author of this article, a member of the Commission on Standards of Education and Experience for CPAs, played an important role in the preparation of the Commission's report in draft form. This article presents the background of analysis and deliberation leading to the Commission's conclusions.

Education for the CPA is a vital subject which deserves serious consideration by practitioners and educators. At the same time it is important to understand fully that this is a subject on which there is not one and only one answer. People who talk on this subject are likely to make statements which sound as if they were citing universal laws of motion. There is nothing of this sort involved.

Accounting is an art which has proven its usefulness in business and in government. During the past fifty years, public accounting has gradually developed into what most of us consider a profession. There are some doubters on this last point, particularly when one

considers that, in certain jurisdictions, a person who is 21 years of age, of good moral character, with twenty-five dollars in hand, a high school education and no experience can become a CPA in good standing and eligible to practice upon passing the CPA examination. However, I will return to this point later. My intention at the moment is to emphasize that the subject of desirable types of requirements for certification of CPAs, whether it be experience or education or both, is not a matter of fact—it is a matter of opinion. Further, I want to stress the point that each person's opinion is almost inevitably influenced by his own background and, in addition, I would like to add a word of warning. All of us are apt to credit an area about which we are relatively uninformed with greater importance than the area actually merits. Those who qualified through experience are likely to have a lingering fondness for the route they followed but at the same time they may be willing to attribute more merit to college training than it deserves. Others like myself who have stayed in the academic paths are likely to credit to experience more than it deserves. The tendency to over-em-

FRANK P. SMITH, *Professor of Business Administration and Director of the Bureau of Business Research, University of Michigan, is Editor of the ACCOUNTING REVIEW and a past president of the American Accounting Association. This article has been adapted by Dr. Smith from a paper presented by him in May 1957 at the Nineteenth Annual Institute on Accounting, Ohio State University.*

phasize the importance of the other fellow's field is constantly with us and we can only be as deliberately conscious as possible of this potential bias. We can cite case studies, we can generalize from known instances, and we can quote statistics to our heart's content—the subject still remains one of opinion, not of fact.

Differing CPA Requirements

The meaning of a CPA certificate is a case in point. This is one of the most complicating features of CPA requirements. What a CPA certificate means depends first upon the requirements of the particular jurisdiction. There are 53 jurisdictions and they have differing requirements. In some jurisdictions, a CPA certificate indicates that an individual has had public accounting experience and has passed the CPA examination. In some jurisdictions the individual has had industrial experience and has passed the CPA examination. In certain jurisdictions the individual has had governmental accounting experience and has passed the CPA examination. In other jurisdictions the individual has had teaching experience and has passed the CPA examination. In some jurisdictions the individual has had specified education beyond high school, no experience, and has passed the CPA examination. In some jurisdictions the individual has had a high school education, no experience, and has passed the CPA examination.

Individuals receiving the CPA certificate may have had prior experience in public accounting, industrial accounting, governmental accounting, teaching of accounting, or they may have had no accounting experience. They may have had no formal education but may be said to have acquired the equivalent of high school training through a specified minimum number of years in un-

specified types of business activity; they may have had formal high school training; they may have completed specified hours of college study or a specified program of college study; they may have completed specified college courses as part of a specified college program; or they may have completed approved postgraduate academic programs. All of this variety exists today and is duly and officially provided for by accountancy laws and regulations. If you think only of your own CPA jurisdiction you may be able to state with assurance what a CPA certificate means. If you think of the exceptions made by your own Board you may begin to have doubts. If you think of the requirements of the jurisdictions adjoining your own, you may have serious qualms. If you consider all 53 jurisdictions, you are likely to wonder if there is any agreement on the matter.

The Problem of Experience

We found when we were preparing the Report of the Commission on Standards of Education and Experience for CPAs* that we had difficulty in separating any consideration of education from requirements of experience. The many CPA jurisdictions have mixed up the problem almost beyond repair. Some jurisdictions have emphasized both education *and* experience; some have emphasized *only* experience; some have emphasized one *or* the other at the discretion of the individual. Education at the college level can be substituted for experience in many jurisdictions; experience can be substituted for education at the high school level in other jurisdictions. All of these combinations would hardly make sense. However, the

* Published for the Commission by the Bureau of Business Research, University of Michigan, Ann Arbor, 1956.

most illogical requirement may make sense if it is adopted of necessity of the moment in order to progress toward a logical and realistic set of standards for the future.

The Commission attempted to analyze the training needed by a CPA in this second half of the twentieth century and after that we attempted to determine whether type A or type B could be best accomplished in educational institutions or through on-the-job experience. This is one of the most important questions in the complex of questions regarding the desirable requirements which a CPA should satisfy. We did not want to recommend more college training, which costs time and money, if comparable training could be provided otherwise. Likewise, we did not want to leave to experience certain types of training which could be obtained more effectively (considering time, cost, and uniformity of quality) through education.

We attempted as best we could to analyze the types of activities performed by CPAs. To begin with not all CPAs are in public accounting. Some members of our Commission considered this point as irrelevant to our principal purpose. I do not. If individuals are being recruited for controllership, for top governmental jobs or for teaching assignments, with the CPA certificate as one of the principal requirements, I believe that these individuals need to be considered in reaching an opinion about desirable standards of education. In addition such individuals may have been in public accounting and they may return to public accounting. The particular means of employment at a particular point of time should not rule them out of consideration.

We then considered the type of work the public accountant is doing in public accounting. He may be doing write-

up work, installing systems, preparing tax returns, performing management services, or performing an audit. CPAs do many types of work some of which are heavily endowed with public interest and others which at best have little relevance to public interest. The CPA in public accounting is like the CPA in private accounting in one respect—the means of earning a livelihood at a moment of time is not important. What is important is that he has qualified for a certificate and as long as he keeps himself in good standing in the jurisdiction in which he is certified, he is a member of the profession of public accounting. The Commission, at least a majority of the members, felt that the fact that an individual had met the requirements established by a jurisdiction and had been granted a certificate was more important than the means by which he is presently earning a living.

Types of Accounting Practice

Another point to be considered is this: what kind of practice are we assuming that the graduate of our educational system will enter? There are great differences among public accounting firms in size, specialization, difficulty of engagements, types of training, and other factors. We might argue that a young man or woman training for public accounting in an agricultural state would have little need for an extensive knowledge of consolidated statements, whereas another person planning to enter public accounting in an industrial area might have little need for a knowledge of tax provisions affecting farmers. These arguments were considered and discarded. We have no assurance that the individual will remain in the type of practice he first enters or that the public accounting pattern of the area will remain unchanged. Our educational pro-

Education for the CPA

gram should not be aimed at providing the individual with what he will need when he first enters practice. We should be providing the individual with an education which will serve as a basis upon which he can add experience with maximum effectiveness.

Experience Not Belittled

This brings us to the subject of experience which J. S. Seidman and Richard S. Claire have dealt with so eloquently in their Statement of Dissent. I am not going to debate this, but I want to be sure that the position of the majority of the Commission is understood. We did not belittle experience. We went to great pains to point out the valuable attributes of a public accountant which can be obtained only through experience. I am belaboring this point because some of the publicity regarding our Report suggests that we hold experience in low esteem. This is most emphatically not the case. The principal point of difference between the dissenters to our Report and the majority of the Commission is when experience should be obtained after young people entering public accounting have had the advantages of a type of educational preparation which we propose should be developed but which does not now exist. An argument about the performance of such additional preparation will be appropriate when, as, and if it is developed; until then we are merely arguing about "ifs."

College Graduation

The recommendations of the Commission on Standards of Education and Experience for CPAs are divided into two parts. The first part concerns what we call the "transitional goal." We intended this to be an interim proposition which would differ among the 53 jurisdictions. This was a difficult set of

recommendations to frame because of the differences which exist among the many CPA jurisdictions. We suggested three points as standards for the qualification of CPAs: college graduation, satisfactory completion of the CPA examination and two years of public accounting experience.

With respect to the college graduation requirement, we were thinking of graduates from a school of business administration with a major in accounting. However, we recognized that many people enter public accounting who are college graduates but not of schools of business administration. At one extreme we have people with training in engineering, chemistry, physics, mathematics, and the like. At the other extreme are graduates of liberal arts with majors in history, English, languages and other fields. I mention these as being "extremes" because the first group will have completed mostly technical academic courses while the other type of graduate will have completed mostly "general" or "cultural" courses. We recognized that these are not comparable educational preparations but we also recognized that there is an important limit to the degree of precise detailing which is feasible. The Commission is fairly well agreed that a substantial proportion of college study should be obtained in the "general" or "cultural" areas but we did not want to bar the engineer or the college graduate with a major in one of the many fields of scientific interest. We simply recommended college graduation which should either (a) include an accounting major as a part of the program or (b) be supplemented by completion after graduation of an accounting major. The additional study necessary to add the equivalent of an accounting major to college training in some other field could be accomplished through full-

time or part-time study; we took no position on this point. Likewise, we did not attempt to say what should be included in an accounting major. We did refer favorably to a report by a committee of the American Accounting Association and to the standards of the American Association of Collegiate Schools of Business. The creation of a "major" is a technical problem which can be accomplished more effectively by the individual school than by a Commission operating across the board.

The CPA Examination

Our second recommendation is the satisfactory completion of the CPA examination. The only argument we had on this point was regarding the character of the examination. We felt generally that the scope and make-up of the examination was not one of our principal points of consideration. We did suggest that college graduates with the specified accounting major be permitted to sit for the examination immediately after graduation. This is a mildly controversial point but not a matter of great moment. It is perhaps more important in jurisdictions such as Ohio which require experience before an individual may attempt the examination. We were told repeatedly that the fact that an individual cannot attempt the examination until after he has had several years of experience results in individuals going into other types of activity. This is an example of so many facets of the whole problem of standards for CPAs. There is no possible way of proving this point but the frequency with which it was voiced suggests that there may be something to it. Apparently it is not whether people pass or fail the examination—the issue is simply the prohibition against attempting it before acquiring experience in public accounting.

Recommendation as to Experience

Our third recommendation calls for two years of experience in public accounting under the guidance of a CPA. We have been asked why we did not give arguments to justify our recommendation of two years experience with a CPA. We recognized in our Report that an individual might obtain worthwhile and valuable experience with a non-certified public accountant, in industry or in government. We stated that the type of experience obtained was of more significance than the label attached to the employer. However, the instances in which the non-public accountant employer provides the individual with experience which is equivalent to that which he would have obtained in public accounting is the exception rather than the rule, and consequently we recommended experience with a CPA as being most typically of the desired variety and quality. I think the only reason we did not include arguments on behalf of such experience is that we thought the proposition was so obvious that it needed no justification.

Current Educational Requirements and Achievement

Our recommendation that CPA candidates be required to complete a four-year college program with a major in accounting has produced much less argument than we expected. None of the dissents was based on this point. Possibly the fact that most young people entering public accounting today are college graduates may explain why our recommendations have not aroused controversy.

Only a few CPA jurisdictions have established college graduation as a condition to be satisfied by the potential CPA. New York, New Jersey, and Florida require college graduation; California, North Carolina and Tennes-

see require two years of college; Illinois requires thirty hours of college study. Connecticut will require college graduation beginning in 1959. Mississippi requires completion of an approved course of study in accounting and related subjects but not completion of formal classroom training. With these exceptions, only high school graduation or the "equivalent" is required. However, it is obvious that performance is running far ahead of requirements. For example, the American Institute of Accountants provided us with an analysis of the first-time candidates on the examination of May, 1953. Of the successful candidates, approximately 80 per cent were college graduates. Of the unsuccessful candidates, 62 per cent were college graduates. For all first-time candidates on this examination, 64 per cent were college graduates. Generally, we can say that a substantial and increasing proportion of CPA candidates today are college graduates although there are, of course, some variations among jurisdictions. The states which require college graduation naturally rank at the top with 100 per cent; jurisdictions which require only high school or the equivalent have lower percentages but even for such jurisdictions the majority of the candidates, particularly of the successful ones, are college-trained. It is logical in any field to expect that educational performance would run ahead of requirements, but it is doubtful if any other profession has such a marked difference between educational requirements and educational achievements.

The Commission recognized that our recommendations would present individual jurisdictions with quite different problems. Those jurisdictions which presently require college graduation obviously have no particular difficulties

other than those already encountered such as the make-up of the curriculum for an accounting major and which colleges to recognize. Jurisdictions which now require two years of college have already completed part of the transition to our recommended goal. However, these two groups of jurisdictions are distinctly in the minority. Most jurisdictions require only high school or the equivalent. For the benefit of these jurisdictions we suggested a number of steps to be taken in sequence. Initially we had included the suggestion that these steps be scheduled at intervals of five years, but this detail was finally omitted.

The first step we suggested for the jurisdiction which is moving from a requirement of high school education is completion of two years of college study with no limitations on what is studied. The second suggestion is two years of college study and, in addition, completion of an accounting major including related courses in business administration. We added the phrase "related courses in business administration" because we felt that the individual should complete academic courses in the core areas of business administration including marketing, finance, management, and statistics, and some study of economics, in addition to accounting. This second recommendation has apparently caused confusion. For example I have had letters to the effect that if we recommend two years of college and completion of an accounting major, we are actually recommending more than two years of college. We intended to do this. We were thinking here of the individual who completes two years of college either with or without courses in business administration and then adds to his training by completing courses in business administration. The

study of business administration might be done on a part-time basis and could amount to the course and credit equivalent of two more years of academic study. We were more concerned in this recommendation with the subject areas covered than with the number of years of full-time study.

Our final recommended step is four years of college either with or supplemented by the equivalent of an accounting major. Again I should mention that we were not attempting to define an accounting major. We consider this to be a matter to be worked out cooperatively by educational institutions and members of the public accounting profession.

It will be noted that we have recommended strengthening educational requirements and, for some jurisdictions, strengthening experience requirements. The Commission was agreed that our present educational programs are in general not adequate to serve as a basis for preparing individuals for public accounting as CPAs. This point, like that of the weight to be accorded experience, is a difficult one in which to obtain objective evidence if such can be said to exist. We all have our opinions which are conditioned heavily by our individual backgrounds, whether we did or did not attend college and, if we did, the particular school, which teachers we had, what experience we have had since, how we are now earning a living, what our wives think of our vocation and many other factors.

The CPA Examination and Effectiveness of College Training

Some may ask: "If college training is so effective why don't college graduates pass the CPA examination?" There are several answers to this. To begin with some of them do. It is difficult to appraise this point since college gradu-

ates without experience are not permitted to sit for the examination in many jurisdictions. To illustrate, in the May, 1953, examination which I mentioned previously, college graduates without experience represented 18.8 per cent of those candidates who were successful on their first attempt, and 16 per cent of all unsuccessful candidates. In contrast, college graduates with a maximum of two years of public accounting experience made up 21.4 per cent of the successful and 17 per cent of the unsuccessful candidates.

Another set of figures are taken from the records of the performance of one school during a five-year period. The individuals involved all sat for the CPA examination without experience but all were members, in their senior years, of one particular CPA review course. Further, these individuals sat for the examination in May before graduating in June. This was a small group and I suspect there may have been some screening before individuals were admitted to the review course. However, for the record, 15 per cent passed all four parts, 26 per cent passed three parts and 7 per cent passed two parts, or 48 per cent passed two or more parts. These figures prove merely that it is possible for college graduates without experience to pass the examination. The passing achievement will be conditioned very heavily of course by the basic intelligence of the individual and the quality of training he receives in his academic courses.

I am thoroughly convinced that little can be proven by statistics of CPA examinations. This is not intended as a derogatory comment. There are simply too many variables, too many loose ends, to permit any clear-cut, objective conclusions to be drawn from available data.

I believe that it is much more important to have a clear understanding of what can be expected of a college graduate. We all know that there are tremendous differences in the abilities of individuals. The range of abilities may be reduced for graduates of a given school, depending upon the type of admission requirements and standards of instruction and grading, but important differences in abilities are still likely to be present. From the over-all standpoint, the academic standards of all schools must be considered.

Accountancy Boards are inclined to place entirely too much weight upon the possession of a diploma. If all graduates were from certain selected schools I would raise no objection. However, we must consider that there are a very large number of schools which offer programs in business administration. Graduation from any one of these schools may mean much or little depending in part upon the abilities of the individual and in part on the academic standards of the school.

One of the large publishing companies made a thorough canvas of schools offering accounting programs in 1955. A few of these findings will serve to emphasize the problems of mass-education with which we must deal. For example, 1,386 four and two-year schools were surveyed. Of this group, 1,128 offered elementary accounting; 281 offered one semester and 287 offered one year of intermediate accounting; 360 offered a semester of advanced accounting and 173 offered one year; 465 offered a semester of cost accounting and 142 offered one year; 335 offered a semester of auditing, 80 offered a year, and 26 offered auditing practice in addition. A total of 518 offered a course in income tax, 125 offered a semester of CPA review and 35 offered

a year of CPA review. These figures indicate that college training in business administration is widely spread, and with the numbers of schools involved it simply cannot be of high caliber at all of these schools. It is a plain although unpalatable fact that a college degree is not, per se, any particular recommendation of an individual for public accounting. I am not being hypercritical—I am merely being realistic in terms of current educational practices.

College Admission Standards

There are three principal reasons why we should not expect too much from college graduates, particularly in terms of passing the CPA examination. The first is the matter of admissions. Professional schools at the postgraduate level such as law and medicine, and some undergraduate schools such as engineering, forestry, pharmacy and architecture, have been able to establish realistic and effective entrance requirements. This should be done in business administration, but unfortunately it is not the case in many of our schools. The effect of this indiscriminate admission is an appallingly high rate of failures in the early years.

The second point concerns the intellectual quality of students who are admitted to schools of business administration. There have been numerous studies in the past decade with findings which were, unfortunately, fairly comparable. We also collected some data during the work of the Commission which confirmed the findings of the earlier studies. The general conclusion of these findings is that, on the average, students admitted to schools of business are not the equal, intellectually, of those admitted to engineering, the sciences, the arts, public administration, premedicine, prelaw, and numerous other

fields. On the average—or to be more statistically-minded for a moment, at the median—business administration students are well down the list. I would like to illustrate this very briefly. A study in one of our eastern states of approximately 6,500 high school graduates who planned to enter college, indicated that of those planning to concentrate in business administration, only 23 per cent were in the top quarter of their graduating classes. For the whole group of 6,500, 45 per cent were in the top quarter and for engineering, 56 per cent. In terms of I.Q. scores, 9 per cent of the whole group rated 130 or better but of those headed for business administration, only 3 per cent. Engineering had 16 per cent.

Another study of one entering class of one university on the Pacific Coast indicated that of those entering the school of business administration, approximately 9 per cent had high school averages of B plus to A. For all entering freshmen, 16 per cent had B plus to A averages and for engineering, 17 per cent.

The Ranking of Accounting Majors

These data should not be interpreted as meaning that no capable students enter our schools of business administration—it means that the proportion of highly capable students who enter business administration is much lower than in many other fields. However, there is one bright spot in this otherwise discouraging picture. Accounting majors rank very high within the schools of business administration. This does not necessarily mean that they are the best of a bad lot—it more often means that a preponderance of the capable students in a school of business administration concentrate in accounting. We tested this by first obtaining the percentage of

accounting majors of graduating classes, compared with the percentages of accounting majors, who finished their undergraduate careers on the top of the heap. Different schools indicate this in different ways such as membership in honor societies or by class ranking. The end result was the same with remarkable consistency. The accounting majors made up a far higher proportion of the top-ranking students than the percentage of accounting majors would indicate. In the case of my own school, as an illustration, the accounting concentrators represented about 20 per cent of the graduating classes of recent years. However, the accounting concentrators represented approximately 47 per cent of the students ranking near the top of their graduating classes. This proportion, better than two to one, is fairly typical of the data furnished us by other schools.

Some skeptic will immediately ask if accounting courses are easy compared with others. We also checked on this. We tested the grades which accounting majors made in accounting courses compared with the grades they made in nonaccounting courses. The accounting majors did better outside of the accounting courses. Their preeminence in honor societies and in class-rankings was not due to easy accounting courses.

My remarks about business administration programs should not be misunderstood. My comments regarding lack of admission standards and the quality of the student body certainly are not applicable to many schools. However, we have more than 1,000 schools which offer some accounting and perhaps as many as 500 which offer something which might be called an accounting major. The schools of business administration with strong admission and academic standards can prob-

ably compete with other schools in the university in terms of the intellectual ability of their student bodies. For the country as a whole, some of the very best students enter business administration but the percentage is not high compared with science, engineering, law, medicine and certain other fields.

Undergraduate Studies and Professional Orientation

The third point which is important in appraising the performance of college graduates is the orientation of the typical program in schools of business administration. We stressed this in our Report and I would like to emphasize it again.

Schools of business administration are not established to provide professional training in public accounting. A few schools have attempted to offer such training but the so-called professional program usually means nothing more than a limited number of elective courses which are directed specifically towards public accounting in contrast to industrial or governmental accounting.

Accounting courses in schools of business administration, particularly the principles courses, should not be directed towards public accounting. A good course in principles is just as useful for the student who eventually enters public accounting as it is for the student who takes a position with an industrial concern or with the government. It is only in a very few "technical" courses where there is any point in stressing public accounting, industrial accounting, or governmental accounting. As a result the graduate of a four-year college emerges with an accounting major, a modest amount of specialization, and little if any professional training. This is not a criticism of our academic

programs. The undergraduate program is no place for professional training. The students are undecided about their futures, they are immature, and they need background courses before they are ready to undertake professional training.

To return to the CPA examination, there are critics who state that accounting majors can't be much good or those jurisdictions which require college training would have better records. This is a plausible assumption but one which over-simplifies the situation. First, I would like to stress the point I just made, that accounting majors are not being equipped in college to pass the CPA examination. This does not mean that colleges could not equip them to pass the examination but it does mean that the students would be short-changed if the program were directed to this end. Undergraduate training with an accounting major should not be designed to train people to pass the CPA examination and should not attempt to turn out professionally trained individuals. These aims are beyond the capabilities of four years of undergraduate study.

The reader may have decided by now that I am a confirmed skeptic about educational institutions. He may be assured that I am not, but even if I were, we had educators, besides myself, on the Commission from Oregon, Colorado, Michigan, California, Alabama, Ohio, Minnesota, Texas, and New York. We had deans, ex-deans, heads of accounting departments and professors of accounting. We had a very good cross-section on accounting education and there was general agreement that it is difficult for a student to acquire the training he needs in four years of undergraduate study. There were a few murmurs of dissent such as "I can plan

such a program with our students," but generally there was agreement that an undergraduate program of four years is not sufficient to permit training in the many areas demanded today and also permit training for a profession.

If a four-year undergraduate program does not provide the opportunity for training for public accounting, what is the solution? As you know we recommended additional education, but we did not do this in a routine manner. Certainly all of us in education are acutely aware of the cost of education. Those practitioners on the Commission even more than the educators are aware of the demand for new people in the profession and the resulting pressure to get students through fast. All of us were aware that public interest implies not only efficient service but sufficient numbers of individuals in the profession to furnish the services expected by the public. In defensive terms those of us in education were also very conscious of the fact that we might be considered to be gilding our lily. On this last point we have no worries about having an adequate number of students in the next two decades. There are now, for example, some 95,000 college students in Michigan. By 1970, the total is expected to reach 220,000.

I have heard the comment that naturally a group of educators would recommend more college training. I have also heard the comment that any time a group of practitioners and educators get together the practitioners lose their shirts. You see our predicament. If we recommend more education, the reaction is "naturally." If we point to the practitioner group—and a very strong group it is—the reaction is "sold down the road again." The poor educator cannot win.

The decision of the Commission, in which the dissenters joined, to recom-

mend training beyond the four-year undergraduate program has aroused little controversy. This has been rather surprising and may be due in part to the fact that attention has currently been directed at the set of recommendations which are more possible of immediate attainment—our transition goals.

The Long-Range Goals

We made five recommendations which we described as "long-range goals." What is meant by long-range is a matter of opinion. I have had a rather indefinite figure of two decades in mind but we never attempted to settle on any specific number of years.

The recommendations we made for this hypothetical "long-range goal" were as follows:

1. **College Graduation.** By this we mean completion of a four-year program with an accounting major or a four-year program supplemented by an accounting major.

2. **A Qualification Examination.** This has apparently led to confusion. We were concerned with the problem with which some of us have struggled of passing upon college credentials for admission to postgraduate programs. I am sure that most of us are well aware that grading standards are not comparable among educational institutions. A grade of *A* in one institution may be the equivalent of the grade of *C* in another. We were interested in providing a device which would afford the school with a professional post-graduate program with some objective information which would not be dependent upon the variables which are inevitably associated with individual schools. I am not indicating any demerits for any particular school and in fact I have no particular schools in mind. I am merely stating that different schools grade on different bases and there is no adequate

way of comparing grades from different institutions. A qualifying examination was suggested which would be in part based on intelligence and in part on attainment in the field of business administration. The scores would not represent a pass or fail proposition—they would indicate how an individual stands in relation to others taking the examination, which could lead eventually to establishing nation-wide norms.

The practical problem concerning the qualifying examination is, who is to establish and administer the test. At the moment there is no problem involved since there are no professional programs of the type we recommend, but I hope that these will be developing soon. If they develop, we believe the qualifying examination will be a necessity.

3. A Professional Academic Program.

The Commission is convinced that our present academic programs do not provide the type of training which is needed today for the public accounting profession. I have mentioned earlier that an undergraduate program cannot be expected to provide much, if any, training of a professional character. There are many reasons for this, including immaturity of students, indecisiveness (and lack of information and understanding) about careers, and, perhaps of most importance, the simple fact that an individual needs background upon which to build professional training. These considerations led us to recommend that in the foreseeable future CPAs should be graduates of professional academic programs beyond the undergraduate level.

The usual reaction to our recommendation for a professional program is that we are proposing a graduate program. I don't want to get involved in some of our more complicated pedagogical problems, but I would like to

point out that graduate and professional programs are pointed in different directions and have different philosophies. We are proposing a professional program which is oriented specifically towards the practice of public accounting as a CPA. We are assuming that the public accounting profession will permit educators to delve into its files of reports, working papers, tax returns, and other materials in order to develop case studies which will, with certain unavoidable limitations, indicate what the student may encounter when he enters the practice of public accounting. Our professional program should include principles, philosophy, and ethics, but these areas should be related to public accounting and, perhaps most important of all, the student group would be composed of individuals with a common vocational aim—practicing as a CPA in public accounting. This would be a marked contrast to that generally found at the undergraduate level where a given class usually includes individuals headed for public, private, and governmental accounting, and numerous non-accounting vocations.

We did not attempt to spell out in detail what the curriculum of the professional program should include although we mentioned certain areas such as communications, auditing principles and standards, tax practice, accounting systems and controls, standards of professional conduct, administration of a public accounting practice, accounting principles and their applications, and business policy. We hope that individual schools will experiment with different types of programs. There is no reason to assume that one and only one type of curriculum can be effective. There surely can be many ways of achieving the academic goals we have in mind.

4. Accreditation of Professional Programs. This is a controversial matter

in the field of education but is probably of little interest to you. Professional groups have invaded academic circles through accrediting schemes of various types until educators have lost their patience. At the moment, non-academic accreditation is thoroughly in disrepute, due largely to aggressive tactics and to so-called standards which conflict with administrative practice within individual colleges or universities. The Commission recognized that the accreditation of the proposed professional programs will require time, funds, and patience, if the accrediting method is to be established at a level of integrity which is recognized alike by academic institutions and by accountancy boards. However, we believe that accreditation is essential if we are to avoid another mushrooming of low-quality programs such as we have already experienced in accounting at the undergraduate level.

5. Internship Program. Internship programs exist in many colleges and universities and there is nothing startling or unusual in this recommendation of the Commission. I should merely like to point out that we are proposing internship as a part of the professional educational program. We are not proposing an internship as experience as some have inferred. We recognize that an understanding of some aspects of business practice, paper work, office organization, and inter-relationships of individuals is essential in order for the student of our proposed program to obtain maximum benefits from certain parts of his academic study.

6. The Uniform CPA Examination. We propose that an individual who has completed the suggested professional program should be admitted to the CPA examination upon completion of the academic program and, if he succeeds in passing, that he be given his cer-

tificate. Here is where the majority and the minority of the Commission part company.

Please note that for the transitional period the Commission proposes that the CPA certificate be withheld, even though an individual has passed the CPA examination, until he has fulfilled whatever experience requirements have been established by the particular jurisdiction. We proposed two years but this figure is not a matter of great moment. The principal difference between the majority and the minority of the Commission concerns when the certificate might be awarded to an individual after the professional program we propose has been developed and is in operation. At that time we propose that greater reliance be placed upon the educational process and that the certificate be granted to the individual who has completed an undergraduate college program, including an accounting major, has taken the proposed qualifying examination, has been selected for admission to a professional program of study, has completed this program, including an internship in public accounting, and has passed the CPA examination. This individual is not an experienced public accountant, but surely he would be well prepared to begin his public accounting career, with the hazards of the CPA examination behind him, and without endangering the public welfare. He now needs to acquire experience—the majority of the Commission recognizes this and we went to great pains to emphasize this in our Report. We believe he should be well equipped to absorb with maximum effectiveness the important attributes which can be acquired only through experience.

In final analysis the only important difference between the majority and the

minority of the Commission is one of faith. The minority takes the position that educational programs, no matter what the type, scope, extent, duration, or quality, can never bring young men and women to a point where they can be trusted with a CPA certificate. The majority of the Commission believes "the formal educational process can be made so effective and so purposeful in nature that it will constitute the principal method of preparation for a career in public accountancy as a CPA." Further, the majority feels that when, as, and if this has been achieved that it should be recognized by appropriate changes in accountancy laws and regulations.

Summary

In summary, the recommendations of the Commission reflect two different points of view. The long-range goals place greater reliance on education than is presently accorded but it must be re-

membered that the Commission is anticipating the development of a type of professional academic program at the postgraduate level which is not now available. Further, the Commission anticipates the development of an examination to assist in selecting students and a system of accreditation for the proposed academic program. All of this is to be accomplished in the future. In the meantime, the majority of CPA jurisdictions may find it desirable to reconsider their accountancy acts and related regulations. A number of revisions have been proposed in recent months and it is hoped that there will be many more in the next few years. It is important that standards of education and experience for CPAs be reviewed and brought up to date, and, above all, that such changes be made in a manner which will not bar experiments with educational programs which are needed if we are to attain the Commission's long-range goals.

The Language of Accountants

Any occupation of man that is related to an extensive theoretical and conceptual framework tends to develop variations or modifications of the English language that are peculiarly its own. Both practitioners and teachers must recognize as an occupational hazard the constant temptation to disguise the lack of a fresh or a firm viewpoint by the use of specialized language that can be nicknamed "jargon." The over-development of jargon is a luxury that practising accountants can ill afford as their effectiveness depends upon their ability to convey information to the businessman or "man on the street." . . .

The accountant is engaged in a constant struggle to achieve both brevity and clarity in his reporting. Unless his reports are brief, they cannot be clear; however, they may be too brief and, hence, unclear. If the accountant's reports are wordy, few people will bother to read them. Those who do persevere in wading through the mass of detail will lose the effect of any intended emphasis on salient features. On the other hand, it is fatal to achieve brevity at the expense either of clarity or accuracy. A report that is brilliantly misleading is plainly a worse offense against professional competence and probity than a report that is dull but harmless.

EDITORIAL, The Canadian Chartered Accountant, October 1957

Tax Planning and the Stock Market

By ARTHUR J. DIXON, C.P.A.

This article deals comprehensively with tax planning for the different types of stock market transactions. Considerable emphasis is placed on tax minimization possibilities and on unexpected tax pitfalls.

There is probably no field of economic endeavor today in which tax considerations are given a more prominent role than in the stock market. This article will deal with the problems in this area, which have become increasingly important as investing in stocks and bonds has grown more widespread.¹

Security Transactions—Three Types of Taxpayers

There are three types of taxpayers involved in the stock and bond business—the dealer, the trader, and the investor. A dealer is a merchant of securities. He has an established place of business at which his principal activity is the purchase of securities and their resale to customers at a profit. His income results from the same type of facilities which a merchant in any business provides for his customers—a market place and an inventory.² The dealer's profit does not depend primarily on increases or decreases in the value of the securities in which he deals. A "spe-

cialist"³ on the exchange is considered to be a dealer in the stocks which he handles.⁴

A trader is engaged in the business of buying and selling securities for a speculative profit.⁵ Although he holds his securities primarily for sale, they are, nevertheless, capital assets because all of his sales are made through brokers, on the exchange or over-the-counter and are, therefore, not made to "customers".⁶ Whether a taxpayer's activities are sufficiently extensive to qualify as a business depends upon the facts in each case. Certainly, the trading has to be extensive both in dollar amounts and number of shares traded, and must require a substantial amount of the taxpayer's own time and attention.⁷

The third and largest category is the investor. These are the people who purchase stocks and bonds with a view to current income, to eventual appreciation, or to both, and whose activities in the stock market are not sufficiently extensive to constitute them traders.⁸

Some Basic Rules

The basic rules governing the manner in which capital gains and losses are reflected in net income are as follows:

ED. NOTE. This article has been adapted by the author from a paper presented by him at the 1957 Tulane Tax Institute. The complete proceedings of the Institute will be published by the Bobbs Merrill Co. in the spring of 1958.

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1. All long-term transactions are netted together to arrive at a net long-term capital gain or loss. Similarly, all short-term transactions are netted together to get a net short-term capital gain or loss.⁹

2. The net long-term and/or net short-term results are combined. An excess of net short-term gain over net long-term loss is taxed as ordinary income. One-half of an excess net long-term gain over net short-term loss is includible in taxable income¹⁰ and is subject to the 50% alternative tax.¹¹ The maximum tax on such excess net long-term gain is, therefore, 25%, but, depending on the taxpayer's other income, the actual tax rate may be as low as 10% (50% of the lowest tax bracket).¹² Only \$1,000 of any excess net capital loss (long-term or short-term) is deductible from ordinary income (if the ordinary income is as much as \$1,000)¹³ and the balance is a capital loss carryover to the five succeeding years.¹⁴ The carryover is treated as a *short-term loss* even though created as a result of long-term losses.¹⁵

3. The timing of transactions is vital. A net short-term loss offsets a net long-term gain, thus limiting the benefit of the loss to a maximum of 25%. On the other hand, a net long-term loss reduces, dollar for dollar, a net short-term gain taxable at ordinary rates. The ideal situation is, therefore, to realize all capital losses in a year in which there are only short-term gains. This is, of course, rarely possible. In pre-year-end planning, however, the maximum practical advantage should be derived from the application of these rules. Furthermore, through the use of short sales and other methods to be described, the timing of transactions may be arranged to achieve the best tax result without necessarily interfering with the related economic considerations.

The Holding Period

What constitutes long-term and short-term transactions? A long-term capital gain or loss results from the sale or exchange of a capital asset held for more than six months.¹⁶ A short-term capital gain or loss results from the sale or exchange of a capital asset held for not more than six months.¹⁷ In the usual stock market transaction, there is no question that a sale has been made. Similarly, in the case of a trader or investor the security sold qualifies as a capital asset.¹⁸

In determining whether an asset has been held for more than six months, the count is made on a monthly basis rather than on a daily basis.¹⁹ The long-term period is reached on the day in the sixth month after acquisition which numerically follows the date of acquisition. This is so whether the period encompassed is more or less than 183 days. For example, June 1st to December 2nd is more than six months. If the subsequent day does not exist in the sixth month, the first day of the succeeding month completes a long-term holding period. For example, stock bought on August 29th, 30th or 31st becomes long-term the following March 1st.

It has also been ruled that the holding period of securities bought and sold on a stock exchange is computed with reference to the date the purchase or sale is actually made.²⁰ This is called the contract date or the trade date. The settlement date, which is the date of payment and delivery of the securities, is not used to measure the holding period.

Short Sales

A short sale was originally defined to include the sale of an asset which the vendor did not have or could not deliver.²¹ For tax purposes, this definition has subsequently been expanded to

include a transaction intended to be a short sale, delivery of which is made with borrowed securities, even if the taxpayer actually owns an equivalent amount of the securities sold short.²²

A short sale is not considered consummated for tax purposes until delivery has been made by the taxpayer and the short sale closed.²³ Therefore, the timing referred to previously may be substantially assisted. If a taxpayer has a gain or loss which market judgment indicates should be immediately realized, a short sale of the security may be made and closed in a subsequent year. It is only in the year of closing that the transaction will be recognized for tax purposes.

In addition, it may be advantageous for a taxpayer to set up long and short positions in substantially identical securities with a view to realizing a short-term gain or loss, depending on the circumstances, in one year, with the offsetting transaction in the next year.²⁴ This may be accomplished if the market moves in either direction, by closing out one side of the position at the end of the year and the other side at the beginning of the next year.

The above rule is of assistance not only in the timing of transactions, but also in the postponement of tax.²⁵ If, for example, a taxpayer has a short-term capital gain which he wants to realize, but has very substantial ordinary income in the same year, he may make a short sale, and close the transaction in the next year. The short-term gain will be taxable in the subsequent year. The taxpayer has postponed his tax, and may also have shifted the gain into a year in which either the tax rates have decreased or his other ordinary income is less.

Even though short sales are very useful in tax planning, as shown above, there are several objectives which they

may no longer accomplish. Despite the fact that a short sale is not consummated for tax purposes until it is closed, a short-term gain may not be converted into a long-term gain by making a short sale of a security not yet long term and closing the short sale after the security has been held for more than six months. Similarly, artificial long-term gains and short-term losses may no longer be created, as they once were, by selling short a security held for more than six months and then, if the market rises, selling the original security at the market and buying in to cover the short position. Both of these very useful applications were possible until 1950. At that time, section 117(1) was added to the 1939 Internal Revenue Code²⁶ which provided the following rules:

1. If at the time of the making of a short sale, a taxpayer (or his spouse) holds substantially identical property, which he has held for not more than six months, or if he acquires such property after making the short sale but before the closing thereof, then:

- a. Any gain on the closing of the short sale is treated as a short-term gain and

- b. The holding period of the substantially identical property is deemed to begin on the date of the closing of the short sale, or on the date of a sale, gift, or other disposition of the property if earlier.

2. If on the date of the short sale the taxpayer (or his spouse) holds substantially identical property which has been held for more than six months, any loss on the closing of the short sale is considered a long-term loss.

Rule (1b) above is applied to the same amount of substantially identical property as is sold short, in the order

of the dates of acquisition. Thus, if a taxpayer holds two 100-share lots, purchased at different dates, both of which are short-term at the time of a short sale of 100 shares, the holding period of the first acquired lot is lost. This is so, even if the short sale is eventually closed with the second lot.²⁷

It should be noted that, if at the time of the short sale, the taxpayer holds both short-term and long-term securities substantially identical to those which were sold short, all of the above rules will be applicable, with the result that any gain on the closing of the short sale will be short-term and any loss on such closing will be long-term.²⁸

Puts and Short Sales

The acquisition of an option to sell property at a fixed price, which is called a "put" and will be discussed at some length later in this article, is considered as a short sale for the purpose of the short-term rules under (1) above. The exercise or failure to exercise such option is considered as a closing of the short sale.²⁹ This rule is not applicable, however, to a put acquired on the same day as the securities which are intended to be used in exercising the put and which, if the put is exercised, are actually so used.³⁰ The securities and put held in this "marriage" must be identified on the taxpayer's records in the manner set forth in the regulations.³¹ The advantage of this exception to the short sale rules is that a taxpayer may limit his loss to the cost of the put without sacrificing the possibility of a long-term capital gain. As a practical matter, however, since a put extending for a period of more than six months is quite expensive,³² the advantage is pretty much limited to securities which may have a substantial swing in either direction.

Substantially Identical Property

The most troublesome problems that have arisen in the application of the short sale rules deal with the question of what is "substantially identical" property.³³ The same language is used in the wash sale provision,³⁴ and the short sale regulations incorporate by reference the wash sale history of "substantially identical."³⁵ Nevertheless, many problems of interpretation have arisen in connection with short sales which never came up for wash sale purposes.

Reg. Section 1.1233-1(d) provides:

"Ordinarily, stocks or securities of one corporation are not considered substantially identical to stocks or securities of another corporation. In certain situations they may be substantially identical; for example, in the case of a reorganization the facts and circumstances may be such that the stocks and securities of predecessor and successor corporations are substantially identical property."

Suppose that the directors of A Corp. and B Corp. agree to a merger, by the terms of which the stockholders of A Corp. will receive one share of B Corp. stock for each share in A Corp. These facts are announced in the newspapers and, the stock market being a sensitive instrument, the value of A stock starts fluctuating pretty much in relation to changes in the price of B stock. Is the A stock and the B stock at this point substantially identical property? The merger has not as yet been approved by the shareholders and experience has demonstrated that something can happen to prevent its completion almost up to the last minute.³⁶ The Internal Revenue Service has refused to rule as to when property becomes substantially identical in such situations.³⁷

It is the writer's opinion that the A stock and the B stock are not substantially identical at least until the merger

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has been approved by the shareholders of both corporations. Even after such approval, the merger may still be prevented by law suit or Government action. Nevertheless, the question then becomes much closer. The Internal Revenue Service would probably maintain that the A stock and B stock were substantially identical after the stockholders' approval if the market prices of the stocks fluctuated proportionately to each other.

The regulation goes on:

"Similarly, bonds or preferred stock of a corporation are not ordinarily considered substantially identical to the common stock of the same corporation. However, in certain situations, as, for example, where the preferred stock or bonds are convertible into common stock of the same corporation, the relative values, price changes, and other circumstances may be such as to make such bonds or preferred stock and the common stock substantially identical property."

Suppose that a bond of the A Corp. is convertible into common stock at \$40 per share. When the stock is selling at less than \$40, the value of the bond will reflect its true security value plus, probably, a value for the potential convertibility. When the price of the stock goes above \$40, the value of the bond as a secured instrument is submerged in its conversion value, and its market price will vary directly with increases or decreases in the market price of the stock. There will be, however, a range of stock prices bracketing \$40 a share where neither of the two clear-cut situations will be applicable, but the bond and stock will move erratically. In a ruling dealing with the related problem of the substantial identity of stock warrants and the stock which may be acquired therewith, the Internal Revenue Service merely repeats the tests of relative values and price changes set forth in the above regulation.³⁸ It is the writer's

opinion that the convertible bonds and the common stock are not substantially identical until the stock has reached a value at which the price of the bonds substantially reflects the day-to-day changes in value of the stock.

Dividends Paid on Short Sales

If a taxpayer has a short position in a stock when a dividend is declared thereon, he must pay that dividend to the person from whom the stock was borrowed. The Internal Revenue Service has ruled that such a short dividend is an ordinary deduction.³⁹ Assume a taxpayer sells short before the ex-dividend date.⁴⁰ He covers his short position after the ex-dividend date, at which time the stock, all other things being equal, has dropped in price by the amount of the dividend. He has a short-term capital gain on the short sale which may be offset by what might otherwise be a wasted or disadvantageously used capital loss or capital loss carry-over. At the same time, he has an ordinary deduction, in the same amount, for the short dividend. Of course, commissions paid on the short sale and the covering purchase may cut down or eliminate the tax advantage. Similarly, there is a market risk that the price of the stock will not drop by the same amount as the dividend. These factors have limited the advantage of this procedure, as a practical matter, to situations involving a substantial dividend.

It should also be borne in mind when using short sales for the purpose of timing, postponement of tax, or the creation of ordinary deductions that one or more of the short sale rules previously outlined may inadvertently become effective. Therefore, such short sales, even though very useful, must be approached with caution.

References

1. The 1956 Census of Shareowners prepared by the Department of Public Relations and Market Development of the New York Stock Exchange indicates that at the end of 1955 there were 8,630,000 persons in this country owning shares in publicly-held corporations, an increase of 2,140,000 over early 1952. The present number of shareowners is undoubtedly even higher.
2. Regulation Section 39.22(c)-5.
3. A specialist is a member of the exchange whose duty it is to maintain an orderly market in the stocks in which he specializes. He operates at an assigned trading post on the floor of the exchange, matching all buy and sell orders in his stock, and making purchases for and sales from his own inventory to the extent necessary to insure an orderly market.
4. *Helvering v. Fried*, 299 US 175, 36-2 USTC Para. 9538 (U.S. Sup. Ct., 1936).
5. *C. E. Wilson v. Commissioner*, 76 F (2d) 476, 35-1 USTC Para. 9245 (10th Circuit 1935).
6. *George R. Kemon, et al*, 16 TC 1026 (Acq.); GCM 9656, X-2 CB 127.
7. *Snyder v. Commissioner*, 295 US 134, 35-1 USTC Para. 9344 (U.S. Sup. Ct. 1935); *Commissioner v. Nubar*, 185 F (2d) 584, 50-2 USTC Para. 9502 (4th Circuit 1950) Cert. denied 71 S. Ct. 796; *Schwinn*, 9 BTA 1304 (Acq.); IT 2103, III-2 CB 92.
8. *Eugene Higgins*, 312 US 212, 41-1 USTC Para. 9233 (U. S. Sup. Ct. 1941); *Chang Hsiao Liang*, 23 TC 1040 (Acq.).
9. Section 1222, IRC.
10. Technically, the entire net long-term capital gain is included in gross income, and is offset by a deduction of 50% thereof. Section 1202, IRC. The 50% long-term capital gain deduction is deductible in arriving at adjusted gross income. Section 62(3), IRC.
11. Section 1201(b), IRC. The above rules are applicable to all taxpayers other than corporations. Corporations are not entitled to the deduction of 50% of net long-term capital gain under Section 1202, but pay an alternative tax of 25% of the excess of their net long-term capital gain over net short-term capital loss.
12. Even though the net income, including 50% of net long-term capital gain, exceeds the amounts at which the alternative tax usually becomes applicable, there are situations in which the regular tax rates are less expensive. Assume, for example, a joint return showing a net income after all deductions and exemptions of \$40,000. The tax at ordinary rates is \$14,520. If the \$40,000 includes \$16,000 of net long-term capital gain (representing 50% of the net long-term gain actually realized), the alternative tax is \$14,800. Therefore, in this situation, the tax at ordinary rates would apply.
13. Section 1211(b), IRC. In the case of a corporation, a net capital loss is not deductible to any extent from ordinary income.
14. Section 1212, IRC.
15. Section 1212, IRC. It should be noted that, if there are net capital losses in any of the five years during which a carryover is effective, the \$1,000 deduction from ordinary income comes out of the current year's capital loss and not the capital loss carryover. This prevents the taxpayer from preserving the current year's loss to be carried over for five additional years to the extent of the deduction from current year's income.
16. Section 1222(3) and (4) IRC.
17. Section 1222(5) and (6) IRC.
18. Footnotes 6 and 8, *supra*.
19. IT 3985, 1949-2 CB 51.
20. GCM 21503 1939-2 CB 205; IT 3705, 1945 CB 174. The same rule is applicable to stock exchange sales of bonds even though interest is computed to date of delivery. IT 3442, 1941-1 CB 212. In practice, the same rule has been applied to over-the-counter transactions. Cf. *Arthur E. Otto*, 37 BTA 479, remanded per curiam on joint motion of the parties with directions to enter an order pursuant to their stipulation, 101 F (2d) 1017 (4th Circuit).
21. *Provost v. U.S.*, 269 US 443, 1 USTC Para. 153, (U.S. Sup. Ct. 1926).
22. *Henry F. Dupont*, 38 BTA 1317, Affirmed 40-1 USTC Para. 9293, Cert. denied 311 US 657; *Robert W. Bingham*, 27 BTA 186, (Acq.); GCM 7451, IX-1 CB 81.
23. Regulation Section 1.1233-1(a)(1).
24. For example, a taxpayer with a net short-term loss offsetting a net long-term gain in 1957 might find it advantageous to create a short-term gain to offset the short-term loss in 1957, and a short-term loss, deductible from short-term gains, at the beginning of 1958. The same objective may also be accomplished by means of future contracts to buy and sell commodities.
25. In its original report to the Mills Committee, the Treasury Department listed the postponement of income resulting from short sales as one of the unintended tax advantages. In the Technical Amendments Bill of 1957, however, there is no provision preventing the use of short sales as outlined above.
26. Section 1233 of the 1954 IRC is identical in all important respects.
27. Regulation Section 1.1233-1(c)(6) example (2).
28. Regulation Section 1.1233-1(c)(6) example (5). The mandatory application of these rules created a hardship in the case of Wall Street professionals. Many such taxpayers engaged in arbitrage operations. The purpose of such operations as commonly used today is to take advantage of a temporary difference in price between one security and another security for which the former may be exchanged. For example, in the case of convertible bonds, when the stock has gone above the conversion price, the price of the bond and the price of the stock will generally fluctuate in direct relationship to each other. If, temporarily, the price of the bonds will be down in relation to the price of the stock, the arbitrageur will purchase the former and immediately thereafter sell the stock into which the bonds are convertible. He will then convert the bonds into the stock and use the stock so received to close the sale. The stock exchange classifies such sales for its purposes as "short exempt," but the Internal Revenue Service ruled that the sales were short sales for the purpose of the application of Section 1171(f) of the 1939 Code. Rev. Rul. 154, 1953-2 CB 173. As a result of this ruling, it was almost impossible for taxpayers engaging in arbitrage operations to realize a long-term capital gain on the same securities set aside for investment. Each arbitrage short sale would have the effect of moving forward the holding period of the investment security. To remedy this situation, subsection (f) was added to Section 1233 in 1955. This subsection provides that arbitrage short sales will only affect the holding period of a non-arbitrage long position to the extent that such short sales exceed the long securities held for arbitrage purposes.
29. Section 1233(b), IRC.
30. Section 1233(c), IRC.
31. Regulation Section 1.1233-1(c)(3) provides: "If the option itself does not specifically identify the property intended to be used in exercising the

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option, then the identification of such property shall be made by appropriate entries in the taxpayer's records within 15 days after the date such property is acquired. . . ."

32. For example, the cost of a six-month-and-ten-day put on 100 shares of U. S. Steel at the present market price is \$525.

33. The short sale rules are applicable to commodity futures which are capital assets in the hands of the taxpayer. Section 1233(e)(2)(A), IRC. On the other hand, "in the case of futures transactions in any commodity on or subject to the rules of a board of trade or commodity exchange, a commodity future requiring delivery in one calendar month shall not be considered as property substantially identical to another commodity future requiring delivery in a different calendar month."

Section 1233(e)(2)(B), IRC. Thus, commodity futures in May wheat and July wheat are not considered substantially identical property. Reg. Section 1.1233-1(d)(2). A taxpayer may avail himself of this exception to set up a long-term gain and an equivalent short-term loss. *Example*—On January 1, 1957, Mr. Smith enters into a contract to buy 10,000 bushels of September wheat at \$2 per bushel. At the same time, he enters into a contract to sell 10,000 bushels of October wheat at \$1.95 per bushel. By June 30, both September and October wheat have gone up 30 cents per bushel. He closes his sell contract on July 1st and has a short-term loss of \$3,000. The next day he closes his buy contract, realizing a long-term gain of \$3,000. Of course, this presupposes that the market prices of the September and October wheat will fluctuate in exactly the same amounts. This is not necessarily so, and an economic loss may result from the transactions which outweighs the tax saving.

In addition to the above exception, there is a provision granting relief to "arbitrage" transactions in commodity futures. Section 1233(e)(3), IRC. This relief parallels, with some differences, the provision for "arbitrage" transactions in securities. See footnote 28, *supra*.

In other respects, the comments made in the article concerning the use of short sales to assist in the timing of transactions and the postponement of tax are equally applicable to commodity futures.

34. Section 1091, IRC.

35. Regulation Section 1.1233-1(d)(1).

36. For example, the exchange of Allegheny Corporation old preferred stock for new preferred stock was physically under way at the time a court injunction prevented its completion. The injunction was issued on November 21, 1955, and the final decision as to whether or not the exchange will go through has not as yet been made.

37. When the stock or securities to be issued pursuant to a proposed reorganization plan are not presently in existence, the stock exchange recognizes "when issued" trading in such property. Section 1233(e)(2)(A) states that the short sale rules are applicable to stocks and securities, including stocks and securities dealt with on a "when issued" basis.

Regulation Section 1.1233-1(c)(6) example (6) deals with the purchase of stock of one corporation and the sale "when issued" of the stock of another corporation to be received in exchange for the stock purchased pursuant to a particular proposed plan or reorganization. The conclusion in the example is, however, based on an assumption that on the basis of all the facts and circumstances existing on the day the sale contract is made, the stock contracted to be sold "when issued" is substantially identical to the old stock held.

38. Rev. Rul. 56-406, IRB 1956-34, 12. Apparently, the Internal Revenue Service considers the question as to the exact point at which such securities become substantially identical to be one of fact with respect to which it will not rule in advance.

39. IT 3989, 1950-1 CB 34. The Internal Revenue Service has also ruled, in an unpublished letter ruling, that the cost of a stock dividend on an open short position is an ordinary deduction. This ruling would, presumably, not be applicable to stock distributions in the nature of split-ups. No ruling has as yet been issued as to the treatment of the cost of stock rights purchased by a taxpayer to satisfy his obligation resulting from an open short position.

40. The ex-dividend date is set by the stock exchange. It is usually, though not necessarily, a few days prior to the record date. The dividend on any stock sold on or after the ex-dividend date belongs to the seller rather than the purchaser.

Reporting Weaknesses in Internal Control

The examinee usually expects his auditor to report material deficiencies, and to recommend improvements, in the system of internal control. For his own protection, the auditor usually finds it desirable to place himself on record with his client concerning significant weaknesses in the internal accounting arrangements.

Sometimes the auditor does this in his long-form report. I think, however, that comments of this kind are more likely to be effective if they are set forth in a separate letter or memorandum. Of course, any comments the auditor makes in a separate document should not be of such a nature that, when considered with his report, they would tend to cast doubt on the reasonableness of his opinion. Ordinarily, such a separate letter or memorandum might be addressed to the chief accounting officer of the examinee, but there may be circumstances in which . . . it should be addressed to the president of the company or the chairman of the board . . .

Weldon Powell, "AUDITING AND INTERNAL CONTROL," The Chartered Accountant in Australia, August, 1957

The CPA Looks at Operations Research

By MICHAEL SCHIFF, C.P.A.

Operations Research is a new science which is designed to provide management with more reliable data upon which to base decisions and to evaluate the results of alternative courses of action. This article suggests the need for CPAs to recognize the business problems to which O. R. techniques can be successfully applied.

It is a truism that the professional practice of accounting has undergone significant changes in the last twenty-five years and will continue to change in the future. Beyond the usual audit, statement preparation, systems and tax assignments, there is quite a difference between the traditional function of adviser and the wide range of management services currently performed by the professional accountant.

These changes have affected the practitioner with the relatively small practice as well as the larger firms. The recent experience of a CPA in Brooklyn with some twenty-five small clients, utilizing a microfilm camera to copy the client's records and employing a junior to examine the material at his own office for the purpose of audit and report, is

a dramatic illustration of a change in the practice of accounting. Possibly not as dramatic but even more significant is the increasing number of special assignments undertaken by the professional accountant as his skills are utilized by business management.

This article will concern itself with one of the modern approaches to analysis called "Operations Research" or O. R. which is bound to affect the accountant's role as adviser to management. This impact is not restricted to the large firm but just as our Brooklyn CPA discovered a useful tool for more effective utilization of time and effort, the small practitioner as well is bound to feel the impact of these new approaches and methods of analyses.

What Is Operations Research?

O. R. can be defined as the organized applications of the methods and techniques of science to business problems. The application of the "scientific method" to business problems is hardly something new. What is new in O. R. relates to the fact that business operations have become more and more complex and recent developments in the sciences have yielded effective new tools

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for analyzing and synthesizing the situations faced by business management.

It is suggested here that O. R. has developed from elementary approaches to problems to a rather refined and specialized kind of activity. One can cite an illustration from the early years of O. R. which relates to World War II days, a period during which O. R. made a significant contribution. One of the earliest cases is cited by Solandt:

"It had been taught for years that you must never fire a long burst from a machine gun because the gun vibrated so much, it shook you off your aim. It was only the first 2 or 3 bullets out of a burst that hit the target. One of our eager young scientists did not believe anything that he was told; he took some colored crayons and colored a bunch of bullets. He was able to show that consistently, the only rounds that hit the target were the last round of the burst and not the first."¹

In a relatively short space of time, some very powerful tools of analysis have been developed. What are these tools? What should one know about them? Where can they be used? How do they affect the professional accountant? These are some of the questions we shall try to answer.

The Inventory Problem—Conventional Approach

It might be desirable to approach some of the answers by using a specific problem. The accountant is quite familiar with the inventory problem. The typical approach to inventory control is through control of turnover suggesting that the greater the number of turnovers the more desirable the result. The cost accountant has tried his hand at this same problem. Concerned with perpetual inventory records and the costing of material to products, he has gotten into the problem of minimum and maximum levels of inventory. This has resulted in a study of inventory from the view-

point of the fast-moving, medium-moving, slow-moving, and relatively inactive stock leading to the development of activity indexes. This has produced economies stemming from significant decreases in the size of the inventory necessary for a given operation.

Inventories and Related Issues

It is urged here that these are but piecemeal attempts at getting at the heart of a basic business problem. The inventory problem is a much broader one. To begin with there are substantial measurable costs associated with holding a stock of goods. These include interest on invested capital, insurance, taxes, space costs, handling costs, inventory-taking cost, clerical cost, spoilage, repairs, and obsolescence. Estimates of the sum of these costs as a percentage of the cost of the goods themselves range from 15 to 30 per cent. If one assumes a modest company with a \$100,000 average inventory, the annual cost to carry these goods, assuming a 25 percent rate, is \$25,000. If there is currently one turnover a year, a doubling of the turnover rate would mean a saving of \$12,500 and a release of \$50,000 inventory cost for other uses. This puts a price-tag on additional turnovers and suggests the possibility of using some of the savings to produce the additional sales to further increase the turnover.

We hasten to note yet another phase of the inventory problem. This relates to the frequent practice of isolating the inventory problem as a problem unto itself. This is pure fiction. The control of inventory is directly related to (1) budgetary control of the entire operation aimed at maximizing profit on a given investment, (2) sale control to direct sales activities so as to sell the most profitable mix of products to the best possible mix of customers, and

(3) production control to secure the maximum production of products at the lowest possible cost at the right time.²

It would appear that in addition to a number of significant costs incurred in keeping inventory, decisions relative to the size of the inventory must be related to other operations of the business. Mere turnover ratios or even studies of inventory movement describe the situation but do not get down to basic causal factors and the implications of decisions relative to inventory size.

The O. R. Approach and the Inventory Problem

It is suggested here that the traditional approach to the inventory problem is not adequate. The inadequacy is not the result of a lack of adequate tools of analysis suitable for effective analysis. The O. R. analyst in employing the tools of advanced mathematics and statistics possesses the means for coping with the problem and its implications. Accordingly, he can consider the many elements involved in the problem, such as cost to acquire, cost to hold, effect of demand, cost of being out of stock, lead time, etc. He does this by assigning symbols for each of the elements and proceeds to construct abstract models reflecting the interaction between these elements under a wide range of assumed conditions. He can then develop minimum and maximum stock points, reorder points, size of order to be placed, etc., which will result in the best possible return under the circumstance. Frequently, he will urge changes in method of production or sale if they will yield the optimum return. He will test the suggested approaches to establish their validity before recommending them as suitable to the situation.

This approach recognizes that business problems must be approached from the viewpoint of the operation as a whole. It suggests that stable patterns underlie business operations and accordingly the methods of science can be applied. The abstract models employed are but a basic tool borrowed from experimental science and suitable to business problems.

The Accounting Model

The accountant employs a simplified version of the model in carrying out his regular assignment. The accounting system can be looked upon as a model and the accountant studies the effect of a range of transactions and varying treatment of transactions in the accounting records as they affect the model. The O. R. model is far more complex, facing as it does operational problems involving a large number of elements, some rather simple and basic and some extremely complex. The complexity of the problems suggests the employment of the tools of advanced mathematics and statistical analysis.

Other Problem Areas

O. R. has addressed itself to other business problems. It has achieved significant success in applying its tools of analysis to such problems as:³ product scheduling, machinery replacement, production control, facility allocation, investment management and market forecasting.

Limited success has been reported in approaching the following problems: capital expenditure of canning, determining optimum size of operation, plant and warehouse location, advertising effectiveness and allocation of marketing shares.

While this list is not at all complete, it is well to note that the foregoing

items have something in common with the inventory problem examined earlier. The interrelation to other facets of the operation as well as the many variables associated with decision-making in these problem areas, suggest the application of O. R. techniques.

Some of these tools are: linear programming, Monte Carlo technique, theory of games and stochastic process.

What Should the CPA Know About O. R.?

It should be quite evident that O. R. studies complex issues and applies highly developed and refined tools of analysis.⁴ It is quite apparent that the professional accountant normally can hardly extend his professional know-how to this field. Some of the very large firms have hired O. R. analysts and offer this service to their clients. The typical practitioner is hardly able to do so. Yet he cannot ignore progress. He must recognize those business problems, the solution of which depends on the effect of the interaction of many factors. He should recognize the possibility of effective analysis through the employment of a competent O. R. analyst and work with him in providing business management with a choice of alternatives which result from a careful evaluation of all the measurable elements. The CPA does not normally hesitate to urge the employment of an attorney where legal problems arise nor does he hesitate to recommend the employment of an industrial engineer in connection with problems of layout, time-study, etc. The CPA would be remiss in his obligations to his client if he did not urge the employment of an O. R. analyst for the specific problem areas where such service is called for.

References

1. O. Solandt, "Observation, Experiment, and Measurement in Operations Research," *Journal of the Operations Research Society of America*, February 1955.
2. Derived from S. F. Melnitsky, *Management of Industrial Inventory*, Conover Mast Publications, Inc. N. Y. 1951, p. 4.
3. Adapted from A. R. Gardner, "What Is Operations Research", *Duns Review and Modern Industry*, Dec. 1955, p. 47.
4. The paper by S. Beer, "Operational Research and Financial Management" (*Management Accountancy Conference*, Beurne-meuth, England, 1956, p. 1), contains the following observations of an astute British O. R. analyst, which suggest the complexities of O. R. techniques:
"O. R. involves the application of the methods of science in situations where executives require descriptions, predictions and comparisons for the purpose of making decisions. This, you may think, is not a very new pursuit. O. R. is mainly novel in the particular range of techniques it has developed over the last 15 years and the unusual fields in which these techniques have been employed. Thus both novelty and the importance of O. R. might perhaps be measured in terms of the extent to which some of these fields have been abandoned to intuition.
"Everyone is likely to concede that there are aspects of financial management in which intuition plays a greater role than they would wish to see—if only *measures* would be developed. Such measures would have three main features: They would be clearly defined, they would stand in a known relation to other measures, and their standard of accuracy would itself be measured. In many cases where people have abandoned hope of creating such measures, operations research may well be able to help by considering the whole situation to be examined as a system of probabilities. The theory of probability is by now a very extensive subject. It is based on the tripod of pure mathematics, pure logic, and pure statistics. A theoretical treatment of the problem on these bases can usually be translated into practical terms and thence to solutions in measured quantities by the use of some technique which may be indiscriminately borrowed from any of the sciences."

Uniform System of Accounts for Villages

By JOSEPH M. CUNNINGHAM, C.P.A.

The new Uniform System of Accounts for Villages was issued in 1954 and represents the first revision since 1925. This article summarizes the basic principles of the System and clarifies certain of its more unique and technical aspects.

For some years, the present and predecessor Comptrollers of the State of New York have been engaged in an extensive revision of the uniform systems of accounting and reporting for the local governments of the State, and in providing adequate manuals of budget management. A uniform system for counties was issued first, and this has been followed by a uniform system for villages which closely parallels the county system. When the task is completed by the issuance of manuals for cities, towns, and special districts, it will represent a major accomplishment in the improvement of the financial manage-

ment of the local governments of this State.

Under the New York State system of government, the Comptroller has extensive powers and duties with respect to local government finance. He prescribes a uniform system of accounts; establishes the form of financial reports which must be filed with the State annually; makes detailed audits of the accounts of every unit of local government, including special districts, with a few exceptions (such as the City of New York); and exercises certain duties with respect to local borrowings; and debt and tax limitations. In addition to these mandatory duties, the Division of Local Government of his office provides extensive assistance, on a voluntary basis, to local governments in the field of financial management.

An Integrated System

A Uniform System of Accounts for Villages was first issued in 1925, so that the new system* represents the first revision in approximately 30 years.

* The new system is described in the following two volumes issued in 1954 by the Division of Municipal Affairs of the State Comptroller's Office: *Uniform System of Accounts for Villages—Double-Entry Basis*, and *Uniform System of Accounts for Villages—Single-Entry Basis*.

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During the interim, the uniform system was subject to so many unofficial changes that it could hardly be said that a uniform system really existed. The system recently issued conforms closely to the best practices in municipal accounting, but introduces a number of concepts which represent a major advance in uniform accounting. One of the most striking facts with respect to the system is the complete integration of budgeting, accounting, reporting and auditing. A uniformity of terminology, principles and accounts has been established which should be most helpful to village officials, analysts and auditors.

When the revision of the village system was undertaken, it was decided to draft a model system first and then to propose to the legislature whatever amendments of the Village Law were necessary. This was done, and as the legislature accepted most of the proposed amendments, the State Comptroller was enabled to issue a Budget Manual for Villages which is based on modern principles of local budgeting. The Budget Manual requires the use of the Uniform System of Accounts with respect to estimated revenues and appropriations; hence the adoption of a budget in the correct form is the first step in the installation of the Uniform System. An article on Village Budget Preparation and Management appeared in the March 1957 issue of this magazine.

The amendments of the Finance Article of the Village Law became effective on September 1, 1955, and hence the initial installations of the Uniform System were made as of the beginning of the succeeding fiscal year. For most villages, the fiscal year now begins on June 1st, but a small number of villages have elected other dates under conditions prescribed in the Law.

Applicability of General Laws

There are in all 549 villages in New York State, ranging in size from Saltaire with a population of 21 to Hempstead with a population of 29,315. Most villages are now operating entirely under general laws applicable to all villages, but 17 still cling to charters which, in some instances, go back to pre-revolutionary days. The mayor and 2 to 6 trustees are elected every two years, and they in turn appoint all other local officials except police justices. By law, the Village Treasurer is the chief fiscal officer.

The general laws applicable to village finance include acts to raise revenues, to make appropriations and to authorize borrowings. Since the village powers are carefully defined in these laws, a most intensive study of them, as well as of other applicable laws, was made in devising the Uniform System. The villages exercise only such powers as are delegated to them by the sovereign state, and the accounting system must adequately reflect their powers and limitations. Experience with the system in the initial installations has shown that these requirements have been admirably met.

Basic Principles of the Uniform System

The basic principles of the Uniform System may be briefly summarized as follows:

1. The books of account must be kept on a double-entry basis in villages of 5,000 population or over. Villages of lesser population are permitted to use the single-entry basis but are encouraged to use the double-entry system.
2. Accounting is based on a clear separation of funds. The number of funds is restricted to those required by law or modern accounting, and no special funds or accounts are permitted.

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3. Budgetary control of revenues and expenses must be established.

4. The accounting for each fund will include a distinction between current operating and capital expenditures.

5. The encumbering of appropriations is optional during the year, but is required at the end of the year. In the single-entry systems, a sufficient cash balance must be carried over to the new year to discharge this obligation, as the expenses of one year may not legally be paid from the collections of the subsequent years.

6. Inter-fund items, exclusive of reimbursements, will be separately accounted for, so that they may be clearly identified and eliminated in preparing consolidated statements.

7. No surplus adjustments are permitted (with one exception), since all transactions must be classified as revenues, expenses, or exchanges of assets and liabilities. This principle will be developed later in this article.

8. The accounts of the Uniform System will include all activities of the Village. However, Electric, Steam and Natural Gas Fund accounts are omitted, since accounts for these operations have been prescribed by the New York State Public Service Commission.

9. The accounts will be maintained on a modified cash basis.

Funds Established

The funds prescribed in the Classification of Accounts together with the related code letters are as follows:

- General Fund (A).
- Enterprise Revenue Fund (C).
- Water Fund (F).
- Sewer Fund (G).
- Public Library Fund (L).
- Capital Fund (H).
- Special Assessment Fund (P).
- Trust and Agency Fund (T).

Supplementary Accounts:

Capital Indebtedness Accounts (W).

Fixed Assets (K).

A brief explanation of each of these funds is presented in the following discussion.

General Fund (A). This fund will include the accounting for all activities not required by the Manual to be included in other funds.

Enterprise Revenue Fund (C). This fund will be used to account for the operations of a revenue producing undertaking, provided separate accounting is required by Section 8 of the General Law. That section refers to activities financed by borrowings subsequent to January 1, 1950. The fund will also be used in compliance with Section 123:00 of the Local Finance Law, with respect to revenue producing undertakings for which an exclusion from the debt limit has been granted by the State Comptroller.

Water Fund (F). This fund will be used for the accounts of the water operation.

Sewer Fund (G). This fund will be used if sewer rents are established pursuant to the Village or General Municipal Laws. The fund will not be used when sewer operations are financed by ad valorem real estate taxes.

Public Library Fund (L). This fund will be used if a village public library is operated.

Capital Fund (H). This fund will be used to account for all capital projects, except Special Assessment projects, including those financed from borrowed monies. Appropriations for capital purposes which are contained in the General and other Funds, will be transferred to this fund for expenditure.

Special Assessment Fund (P). Special assessment funds will be established for each capital improvement financed

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in part by special assessments on a benefit basis.

Trust and Agency Fund (T). The Trust and Agency Fund includes all monies received by the Village Treasurer in his official capacity, to be held in trust or to be transmitted to others. The purpose of the fund is to separate such monies from the other funds of the village, and to provide for their disbursement in accordance with the provisions of the trusts.

Capital Indebtedness Accounts (W). The accounts of this section are used to record the liability of outstanding capital indebtedness as well as authorized but unissued bonds and capital notes of all funds other than the Special Assessment Fund and, in certain cases, the Water Fund. This group of accounts supplements the balance sheet accounts of the other funds.

Fixed Assets (K). Assets which are of a fixed or permanent nature, such as land, buildings, other structures, machinery and equipment, are included in this group of accounts. They provide a continuing record of the fixed assets owned by the village, and constitute an optional part of the Uniform System. All the fixed assets of all funds will be included, except the Water Fund in some instances.

Funds Omitted. In the fund classification given above, no reference is made to the Electric, Steam or Natural Gas Funds since the Uniform System contains no accounts for those funds. It must be assumed, however, that such funds will be maintained by villages with corresponding operations.

Each fund must be established as a self-balancing group of accounts. The assets of one fund cannot be used for the purposes of another fund, except that certain expenses may be incurred on a reimbursement basis. In the single-

entry system, the separation of the funds will be accomplished by establishing separate cash accounts in the cash receipts and disbursement books. The accounts of the General Fund will be discussed in some detail in this article, and brief reference will be made to the accounts of the other funds.

General Fund—Revenue Accounts

Revenue accounts have been provided in the General Fund in considerable detail. They are intended to provide the Board of Trustees with adequate information for estimating revenues in advance and for comparing actual realization with the estimates included in the budget. At the option of the village, revenue accounts may be subdivided by administrative units, if a detailed analysis of all revenues by the unit concerned is desired.

The revenue accounts are kept on a cash basis, except that in the double-entry system a few important revenues are accrued. These accruals are:

A1001—Real Estate Taxes.

A1401/2—Interest and Penalties on Taxes.

A2601—Reimbursement for Tax Advertising and Expense.

—Various Charges to Other Governments.

—Various Charges to Other Funds.

All revenue accounts are maintained on a gross basis, i.e. debits to revenue accounts are permitted only for the correction of errors, or for the refund of items erroneously or improperly received. In one instance, an appropriation account has been provided to record refunds, namely Account 290-622, Refunds of Real Estate Taxes, in order that this item may be separately stated in the accounts. With this exception, revenue accounts will represent the gross

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amounts received or accrued, less adjustments directly applicable to them.

The Classification of Revenue Accounts included in the Manual provides an account for every type of revenue which the villages normally receive. In case revenues other than those listed

are received, the State Comptroller will authorize additional accounts upon request of the village. A summary of the Revenue Classification of the double-entry system is presented as Figure I. The accounts of the single entry system are similar but less numerous.

Figure I
REVENUE CLASSIFICATION SUMMARY

A1001	Real Estate Taxes (Accrued).	A2210/19	Airport Revenues.
A1025/7	Payments in Lieu of Taxes, and other Tax Items.	A2301/6	State Aid.
A1028	Unneeded Reserve for Uncollected Taxes (Delinquent Collections).	A2749	Other Unclassified Revenue.
A1201/11	Non-Property Taxes.	A2401/3	Federal Aid.
A1301/2	Franchise Revenues.	A2501/3	Interest on Deposits and Investments.
A1401/3	Interest and Penalties on Taxes (Partly Accrued).	A2601	Reimbursement for Tax Advertising and Expense (Partly Accrued).
A1501/6	} Licenses.	A2625/7	Fines, Penalties and Forfeits.
A1599		A2650/1	} Minor Sales.
A1601/6	} Permits.	A2659	
A1699		A2675/6	Sale of Fixed Assets.
A1701/2	Commissions.	A2677	Insurance Recoveries.
A1801/4	Rentals for Lease of Real Property and Equipment (Partly Accrued).	A2680	Other Compensation for Loss.
A1901/10	} Charges for Services.	A2701	Gifts and Donations.
A1919		A2702/5	Contributions for Village Activities.
A1921/29	Charges for Services to Other Governments (Partly Accrued).	A2725/6	Miscellaneous.
A1951/62	} Departmental Fees.	A2727	Refunds of Appropriations of Prior Years.
A1969		A2230	Ferriage.
A2001/10	} Fees and Charges for use of Recreational Facilities.	A2802/19	Interfund Reimbursements.
A2099		A2821	Unused Capital Fund Authorizations Financed by Appropriations.
A2101/3	} Cemetery Income.	A2901/5	Interfund Transfers for Debt Service.
A2109		A2926/30	} Interfund Revenues.
A2201/2	Parking Meter Fees and Other Parking Revenues.	A2939	

The revenue accounts are mainly self-explanatory, but a comment may be necessary on the following accounts.

Unneeded Reserve for Uncollected Taxes—Delinquent Collections (A1028). This account will be used by those vil-

lages which establish reserves for uncollected taxes at 100% of the receivables outstanding at the end of the year, as recommended by the State. The provision for this reserve must be made on an appropriation basis. When suf-

efficient collections have been made in the following year to reduce the total tax assets to a lower figure than the reserve, the reserve is reduced accordingly and the reduction treated as revenue. In effect, this means that the village is taking into the revenues for the year the collections of prior years' delinquent taxes, but at the same time is maintaining a 100% reserve against all uncollected taxes of those years. While the procedure outlined seems cumbersome, it permits accrual accounting for taxes, yet keeps the village close to a cash basis of budgetary expenditure.

Interest and Penalties on Taxes—Partly Accrued (A1401); Reimbursement for Tax Advertising and Expense—Partly Accrued (A2601). Under the New York State system, properties on which real estate taxes are unpaid eight months after the due date should be sold at tax sale. Interest and penalties are added to the tax receivables, and these amounts are credited to Revenue Account A1401. The cost of tax advertising is also added to the receivables, and credited to Account A2601. These accounts are stated to be "partly accrued" as some revenue may be received in cash after the taxes become overdue and before the tax sale is held.

Insurance Recoveries (A2677). This account is used to record receipts for the loss of insured physical assets. Such items are treated as revenues in order to eliminate the possibility of their being set up in special funds or accounts outside of budgetary control. If a recovery offsets an expenditure already charged to Appropriation Expense, the amount may be credited to Appropriation Expense instead of to Revenue.

Gifts and Donations (A2701). All unrestricted gifts and donations are considered as revenues of the General Fund. Gifts for youth projects, or celebrations, are also treated as revenue, since they

represent reimbursement for part of the total village expense for these purposes. Gifts for particular purposes will be entered in the Trust and Agency Fund.

Refunds of Appropriations of Prior Years (A2727). This account is credited with the receipt of refunds of appropriation expenses of prior years, or the cancellation of an encumbrance in balance sheet account A701, Reserve for Encumbrances, Prior Year. Refunds of amounts previously charged to appropriation accounts of the current year are not credited to this account but are credited directly to the appropriation account concerned. The use of this account is one of the methods provided for elimination adjustments of the surplus account, but at the same time giving full information to the taxpayer and analyst.

Reimbursements for Expenses from Other Village Funds, Accrued (A2802/7). These accounts are used for the accrual of charges to other funds for items which represent a combination of various objects of expense, such as repairs made in a central garage, use of equipment, etc. It should not be credited with the regularly divided salaries of individual employees, as for example the Village Clerk, since such items should be divided at payroll time and disbursed directly from the fund or account concerned.

Contributions from the Electric Fund (A2926). This account will be used to record contributions made from the surplus of the Electric Fund. Similar accounts are provided for contributions from other funds. In the accounts of the contributing fund, the item should be treated as an appropriation expense, so that in preparing consolidated statements the revenue may be eliminated with the appropriation.

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General Fund—Appropriation (Expense) Accounts

With respect to expenses, the Uniform System is based on the assumption that no disbursement will be made or reserve established unless an appropriation is made in the budget or a subsequent modification; and that every appropriation will be assigned to an administrative unit, the head of which will be responsible for its proper use. This general rule does not apply to trust, agency, or pledged accounts, but it has been applied strictly throughout the other funds of the Uniform System. The one exception to the rule concerns the payment of bond anticipation notes from the proceeds of bond issues in the Capital Fund.

The Village Law requires that appropriations of the General Fund shall lapse at the end of the year, but also requires the encumbering of appropriations for unpaid invoices and outstanding purchase orders before lapsing unexpended balances. Appropriations made in the General Fund for Capital purposes are transferred to the Capital Fund by cash transfer, and these appropriations remain open in that fund indefinitely.

The appropriation accounts of the General Fund are maintained on a gross basis, and credits to the accounts are permitted only for the correction of errors and for refunds received of expenditures made during the same fiscal year. Refunds applicable to expenses of prior years are treated as revenues, as previously explained.

The Classification of Expense (Appropriation) accounts contained in the Manual of the Uniform System provides accounts for every type of expenditure which the village normally makes. The accounts are numbered and each number must be used by all villages if they have corresponding transactions.

Each account number consists of two elements:

A. The Administrative Unit to which the appropriation is made. Every known unit has been listed in the System.

B. The Object of Expense. The general objects of expense are only three in number and they apply to every appropriation made, as follows:

100—Personal Services.

200—Equipment.

400—Other Expense.

There are certain special objects of expense to be used only for appropriations which are the direct responsibility of the Board of the Village. These are numbered from 500 to 799. Thus each appropriation or expense account has a two part number, as for example: A10-100, A10 indicating the Board of Trustees, and 100 denoting Personal Services. A complete list of the Administrative Units contained in the Manual is presented as Figure II.

The List of Administrative Units consists mainly of organization units, but some—it will be noted—represent the nature of the expense and not an organization. For example, A45 is titled Budget Officer or Budget Expense. Since most villages will not have a separate budget officer, and since the system does not require the proration of salaries of village officials who perform the budget function, Administrative Unit Account A45 will consist only of such expenses as printing the budget, and other contractual services. In order to conform to the principle of assigning all appropriations to an administrative unit, such items as this would be titled, A45-400 Budget Expense, Other Expense (Treasurer), to indicate that the appropriation would be the responsibility of the Treasurer

Uniform System of Accounts for Villages

who acts as Budget Officer in the assumed example.

Use of Objects of Expense

The three objects of expense which are obligatory for all administrative units are used in the following manner.

Personal Services (100). This object of expense should include salaries and wages of employees, and fees for services of non-employees such as appraisers, engineers, auditors, etc. The fees referred to may include incidental expenses, such as traveling.

Equipment (200). This object of expense represents items with an extended term of useful life, and a substantial value. It includes office, shop, and other movable equipment of all kinds. It should not be used for the purchase of equipment excluded from the constitutional debt limit, as appropriations for that purpose may be made only through Account 290-560, Provision for Capital Projects—Capital Fund.

Other Expenses (400). This object of expense represents all other current

Figure II

LIST OF ADMINISTRATIVE UNITS

Legislative

A10 Board of Trustees.

Judicial

A20 Police Justice.

Executive

A30 Mayor.

A31 Manager.

Staff

A40 Clerk-Treasurer.

A41 Village Treasurer.

A42 Receiver of Taxes and Assessments.

A43 Village Clerk.

A45 Budget Officer or Budget Expense.

A46 Village Auditor.

A47 Tax Arrears Board.

A51 Village Assessors.

A54 Village Attorney.

A58 Village Engineer.

A59 Historian.

A60 Election Expense.

A61 Veterans Service Agency.

A64 Planning Board or Expense.

A65 Zoning Commission or Expense.

A66 Zoning Board of Appeals.

A70 Purchasing Officer.

A71 Central Storeroom.

A74 Village Hall or Expense.

A75 Central Garage.

Public Safety

A81 Fire Department.

A82 Police Department or Service.

A85 Keeper of the Pound.

A87 Civil Defense Division or Activities.

A88 Parking Division or Activities.

Streets

A100 Streets—Administrative Expense.

A101 Street Maintenance Expense.

A102 Street Cleaning Expense.

A103 Snow Removal Expense.

A104 Shade Tree Expense.

A105 Street Lighting Activities.

A106 Other Activities—Street Expense.

Sanitation

A120 Sanitation—Administrative and General Expense. (Optional)

A121 Storm Sewer Expense.

A123 Sanitary Sewers and Sewage Disposal Expense.

A125 Refuse Collection and Disposal Expense.

Public Health

A130 Public Health Department.

A132 Registrar of Vital Statistics.

A134 Child Welfare Division.

A136 Cemetery.

Hospital

A140 Hospital.

Recreation

A200 Recreation and Parks.

A204 Museum.

A209 Youth Agencies.

Special Activities

A210 Airports.

A211 Ferry.

A219 Public Dock or Boat Basin or Expense.

Natural Resources

A234 Publicity Expense.

General

A290 Village General. (Board of Trustees)

A300 Debt Redemption.

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expense not included in Accounts 100 or 200, or in the accounts for Special Objects of Expense, Accounts 500 to 799.

The villages are permitted to subdivide Accounts 100, 200 and 400 into as many sub-objects of expense as desired, provided the accounts are numbered or lettered in the same series. For example, Account A10-100 might be subdivided as follows:

A10-101—Board of Trustees—Salaries and Wages.

A10-102—Board of Trustees—Consultant's Fees.

These sub-object accounts may be used in various ways; but it is not recommended that they be used for board appropriation purposes. They may be used for budget officer allocation purposes if that officer is given power to allocate the board's appropriations for the major objects of expense; or they may be treated as expense analysis accounts for information purposes only, but not for allocation or appropriation control.

Special Objects of Expense

Reference was made above to the special objects of expense which the villages must use if they appropriate for certain specific expenses. These were established as separate accounts for management purposes, and for the information of the electorate. All of them are assigned to the Board of Trustees, Administrative Unit A290, for expenditure and are listed in Figure III.

The titles of most of these accounts are self-explanatory but comments on certain of them may be advisable.

Refund of Real Estate Taxes (A290-622). Charges to this account consist of refunds of erroneous payments received, and refunds by reason of cancellation or reductions of taxes through proceedings to review assessments when such taxes have been previously paid by the owner.

Contingent Account (A290-650). This account represents the appropriation authorized by the Village Law to provide for unforeseen contingencies. No expenditures may be charged to this account. The Board may transfer all or any part of the Contingent Account appropriation to any other appropriation account, for expenditure therefrom.

Provision for Reserve for Uncollected Taxes and Assessments, Optional (A290-660). This appropriation expense account is debited by journal entry for all or part of the uncollected current taxes at the end of the fiscal year.

Provision for Reserve for Repairs (A290-663). This account represents an appropriation to the special reserve for repairs. The Manual requires that a check be drawn for this amount and deposited in a separate bank account. This transaction is treated as a charge to the Appropriations Payable account and a credit to the Reserve account.

Accounts are also provided for provisions for other reserves.

Contribution to Electric Fund (A290-670). This account is charged when amounts appropriated by the General Fund are transferred by check to the fund concerned.

Contribution to Capital Reserve Project, Capital Fund (A290-676). This

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account is charged with the amount appropriated by the General Fund when transferred by check to a Capital Reserve Project of the Capital Fund.

Payments to Other Agencies (A290-701/5). These accounts are charged when payments are made on appropriations to other agencies.

Figure III

SPECIAL OBJECTS OF EXPENSE

A290-550	Provision for Down Payments on Bonds, Capital Fund.	A290-663	Provision for Reserve for Repairs.
A290-555	Village Share of Special Assessment Projects.	A290-664	Provision for Reserve for Bonded Debt.
A290-560	Provision for Capital Projects, Capital Fund.	A290-665	Provision for Workmen's Compensation Reserve.
A290-610	Judgments and Claims.	A290-666	Provision for Reserve for Inventory of Materials and Supplies. (Optional)
A290-618	Tax Sale Certificates of Other Governments.	A290-670	Contribution to Electric Fund.
A290-622	Refund of Real Estate Taxes.	A290-671	Contribution to Natural Gas Fund.
A290-623	Taxes on Village Property.	A290-672	Contribution to Water Fund.
A290-624	Tax Advertising and Expense.	A290-673	Contribution to Sewer Fund.
A290-625	Tax Discounts.	A290-674	Contribution to Public Library Fund.
A290-626	Expenses of Village-Owned Property.	A290-676	Contribution to Capital Reserve Project, Capital Fund.
A290-628	Payments to State Retirement System.	A290-677	Contribution to Special Assessment Fund.
A290-629	Payments to State, Assistance to Retired Employees.	A290-679	Contribution to Other Fund (Specify).
A290-630	Workmen's Compensation Expense.	A290-680	Interest on Bonds.
A290-631	Deficiency Appropriation—Police Pension Fund (Transfer to Fund).	A290-681	Interest on Notes.
A290-632	Bond Issue and Note Expense.	A290-701	Payments to Joint Water Districts.
A290-633	Payments to State for Social Security Contribution Fund.	A290-702	Payments to Humane Society.
A290-634	Provision for Receiver's Operating Fund (Transfer to Fund).	A290-703	Payments to Joint Recreation Commission.
A290-635	Celebrations and Concerts.	A290-704	Payments to Library Board or Association.
A290-650	Contingent Account.	A290-705	Payments for Laboratory Supply Station.
A290-660	Provision for Reserve for Uncollected Taxes and Assessments. (Optional)	A290-690 } A290-696 }	Debt Redemption Accounts.
A290-661	Provision for Reserve for Tax Stabilization.		

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General Fund—Balance Sheet Accounts

The balance sheet accounts of the General Fund, double-entry system, are in general accord with the recommendations of the National Committee on Governmental Accounting, and are listed in Figure IV. Comments on those accounts which have unusual features are given in the paragraphs which follow.

Cash for Tax Anticipation Notes (A221). The villages of the State are required to set aside cash receipts from collections of taxes, for the payment of outstanding tax anticipation notes. The balance of this account will therefore represent the amount set aside for payment of such notes when due.

Cash for Bond Interest and Matured Bonds (A223). This account is charged

with amounts deposited in banks to pay bond interest and principal on the due dates. It is contra to Account A629--Bond Interest and Matured Bonds Payable.

Tax Sale Account (A310). This account is a temporary one which is opened on the day of the tax sale. It is charged with the amount of taxes, interest and penalties, and advertising, on property offered for tax sale; and credited with amounts paid by purchasers and the amount of certificates bid in by the Village. No balance remains in this account 10 days after the sale.

Special Reserves: Cash (A480); Investments (A482). These accounts record the assets set aside by appropriation of the Board of Trustees for

Figure IV

BALANCE SHEET ACCOUNTS—GENERAL FUND

Assets		
A200	Cash.	A522 Appropriation Expense.
A210	Petty Cash.	A530 Budget Notes Authorized.
A220	Cash for Budget Note Appropriations.	A599 Appropriated Surplus.
A221	Cash for Tax Anticipation Notes.	
A222	Cash for Revenue Anticipation Notes.	
A223	Cash for Bond Interest and Matured Bonds.	
A250	Taxes Receivable, Current.	
A260	Taxes Receivable, Overdue.	
A265	Taxes Receivable, Military Service.	
A268	Taxes Receivable, Pending Civil Action.	
A300	Rejected Taxes Receivable.	
A310	Tax Sale Account.	
A320	Tax Sale Certificates.	
A330	Property Acquired for Taxes.	
A331	Mortgages on Property Acquired for Taxes.	
A380	Accounts Receivable.	
A391	Due from Other Funds.	
A440	Due from Other Governments.	
A445	Inventory of Materials and Supplies (Optional).	
SPECIAL RESERVES:		
A480	Cash.	
A482	Investments.	
BUDGETARY AND EXPENSE ACCOUNTS:		
A510	Estimated Revenues.	
A511	Appropriated Reserves.	
A521	Encumbrances.	
		Liabilities
		A620 Tax Anticipation Notes Payable.
		A621 Revenue Anticipation Notes Payable.
		A622 Budget Notes Payable.
		A629 Bond Interest and Matured Bonds Payable.
		A630 Due to Other Funds.
		A631 Due to Other Governments.
		A700 Reserve for Encumbrances, Current Year.
		A701 Reserve for Encumbrances, Prior Years.
		A710 Reserve for Uncollected Taxes and Assessments.
		A720 Reserve for Inventory of Materials and Supplies.
		A730 Reserve for Accounts Receivable.
		A840 Taxes Collected in Advance.
		SPECIAL RESERVES:
		A880 Reserve for Tax Stabilization.
		A882 Reserve for Repairs.
		A884 Reserve for Bonded Debt.
		A885 Reserve for Workmen's Compensation.
		A909 Surplus.
		BUDGETARY AND REVENUE ACCOUNTS:
		A960 Appropriations.
		A980 Revenues.

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special reserves. The total of these accounts will equal the total of the contra accounts as follows:

A890—Reserve for Tax Stabilization.

A882—Reserve for Repairs.

A883—Reserve for Bonded Debt.

A885—Reserve for Workmen's Compensation.

Budgetary Accounts: Estimated Revenues (A510); Appropriated Reserves (A511); Budget Notes Authorized (A530); Appropriated Surplus (A599). These accounts record the estimated revenues shown in the budget, plus the appropriated surplus and reserves. They will also include any subsequent modifications of these items approved by the Board during the year, plus the authorization of budget note borrowing under the limitations of the Village Laws. The total of these accounts should exactly equal Account A960—Appropriations, when the budget is recorded on the books and also when subsequent modifications of the budget are approved by the Board. The realization of revenues during the year is recorded in Account A980 Revenues, so that the difference between Accounts A510 and A980 represents the revenues not yet realized.

Reserve For Encumbrances, Current Year (A700). A reserve for encumbrances must be established at the end of the fiscal year for all contractual services received but unpaid, and purchase orders outstanding. The account may also be used during the year at the option of the village. On the first day of the succeeding year, the balance of the account is transferred to A701 Reserve for Encumbrances, Prior Years.

Reserve for Uncollected Taxes and Assessments (A710). The Manual of the Uniform System assumes, but does

not require, that a reserve of 100% will be established for all categories of delinquent taxes. Such reserves must be provided by appropriations in the Budget, or subsequent modifications. In case the budget appropriation is insufficient to bring the reserve to 100% at the end of the year, the Board of Trustees should approve a modification for the necessary amount. If, on the other hand, the amount of the appropriation is more than necessary, the excess appropriation should be allowed to lapse when closing the books. When cash collections reduce the total taxes receivable below the amount of the reserve, the reserve should be reduced accordingly.

Surplus (A909). The balances of the revenue and expense accounts are closed to Surplus at the end of the fiscal year. In addition, surplus will be credited when budget notes are retired; and when tax and revenue anticipation notes are paid from appropriations of current revenues. No other adjustments may be charged or credited to Surplus, since provision has been made in the revenue and expense accounts for all known transactions which might affect surplus.

Enterprise Revenue Fund Accounts

Accounts of the Enterprise Revenue Fund will generally be the same as those of the General Fund, but include a number of accounts not necessary in that fund. All account numbers should be preceded by the letter C. Each Enterprise Revenue Fund should be titled appropriately, as CA Airport Fund, CH Hospital Fund, etc. The accounts of the enterprises will include redemption of debt as an expense, on the same basis as the General Fund, and there will be no provision for depreciation. Statistical calculations of depreciation

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may be made for the fixed assets of enterprise revenue funds, but these will be recorded in memorandum records separate from the general books.

Water Fund Accounts

The foregoing comments with respect to the Enterprise Revenue Funds also apply to the Water Fund. Accounts of this fund will be preceded by the letter F. Villages presently operating accounting systems adapted from that prescribed by the Public Service Commission for water works corporations, or other generally recognized standard systems, may continue such accounts. These systems include depreciation accounting.

Sewer Fund Accounts and Public Library Fund Accounts

The foregoing comments with respect to the Enterprise Revenue Funds also apply to the Sewer and Public Library Funds.

Capital Fund Accounts

The accounts of the Capital Fund consist of balance sheet accounts only, as follows:

Assets

- H200 Cash.
- H450 Temporary Investments.
- H521 Encumbrances.
- H550 Bonds Authorized.

Liabilities, Reserves and Balances

- H605 Retained Percentages, Contracts Payable.
- H626 Bond Anticipation Notes Payable.
- H700 Reserve for Encumbrances.
- H850 Earnings on Temporary Investments.
- H851 Premiums on Securities Issued.
- H852 Accrued Interest on Securities Issued.
- H890 Authorizations.
- H911 Unneeded Balances of Authorizations.
- H920 Capital Reserve Balance.

Since the purpose of the Capital Fund is primarily to accumulate in one fund all the expenditures for capital

projects, except for Special Assessments (and Water in some instances), all appropriations for capital projects made in the General and other funds must be transferred to the Capital Fund for expenditure.

The Authorizations Accounts H890 will include all amounts authorized for expenditure for capital projects, including projects financed from borrowed monies, transfers from the General and other funds and transfers from capital reserves. It should also include, although not required by the Manual, authorizations for the construction of capital assets by employees of the village. The purchase of equipment from current appropriations is not considered a Capital Fund item, unless the cost is excluded from the tax limit computation by the village.

No Surplus Account is included in the accounts of the Capital Fund. However, accounts are provided for H850 Earnings on Temporary Investments, H851 Premiums on Securities Issued and H911 Unneeded Balances of Authorizations. These accounts are not closed at the end of the year, as the use of the balances is specifically covered in State laws. Balances of these accounts at the end of the year are carried forward to the succeeding years until used.

Supplementary Accounts

Supplementary accounts which are not "funds" in the technical accounting sense, are included in the Uniform System based substantially on the recommendations of the National Committee on Governmental Accounting. They include accounts for the Capital Indebtedness of all funds except Special Assessment and, in certain instance, the Water Fund. Bonds and notes are entered when issued, and reversed when paid.

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Fixed Asset accounts are also provided in the Supplementary Accounts. Fixed Assets acquired or constructed are entered and reversed when retired. Accounts are provided for machinery and equipment purchased.

Accounting Forms and Procedures

The Manual of the Uniform System contains numerous instructions regarding the forms and procedures to be used. Nineteen forms are illustrated, some of which are alternates. The villages are permitted to modify the forms in any way desired to adapt them to local conditions.

Journal entries covering all foreseen transactions of a village are included in the Manual. The use of the accounting principles expressed in these entries is a major requirement of the system.

Single-Entry System

The accounts described in the foregoing sections apply to the double-entry system. The accounts of the single-entry system are similar but are fewer in number and omit all balance sheet accounts. The fund classification, budgetary control and general cash accounting principles of the double-entry system apply to the single-entry system. Additional requirements are the keeping of a memorandum control account of taxes receivable and a classification record showing the unrealized revenues and the unexpended balances of appropriations. A detailed record of borrowings made and outstanding, is also required. Non-revenue account numbers are provided which include the various types of general fund borrowings. Cash on hand at the close of the

year is reserved for the payment of outstanding commitments.

Installation of the Uniform System

The responsibility for the installation of the system rests with the village, but assistance is given by the State Comptroller depending on the staff available. Regional and state-wide conferences are arranged for local officials, at which the elements of the system are explained.

Participation of CPAs

It is a matter of regret that the CPAs of the State are taking only a very small part in the installation of the Uniform System and in the subsequent audits. The free systems and audit service provided by the State has had the effect of severely limiting the engagement of independent accountants. While the State has encouraged the villages to call on the services of public accountants, comparatively few of them have thus far availed themselves of such services. Since the State cannot possibly employ enough trained accountants at public expense to cover adequately both the installation of systems and the audit of all municipalities and special districts, the ultimate objective of adequate accounting and financial management in local governments may be long delayed. In addition to villages, it must be remembered that the State must cover towns, cities, counties, schools, fire districts, and others which number in the thousands. The excellent work of the Comptroller in preparing manuals of accounting, budgeting and reporting will not be properly followed through under present conditions unless the role of the CPA is given greater recognition.

New York State Tax Forum

Conducted by BENJAMIN HARROW, C.P.A.

Gain on Sale of Real Estate Used in Business . . . Life Insurance . . . Personal Exemption . . . Disallowed Losses—Sales and Purchases of Securities by Husband and Wife.

Gain on Sale of Real Estate Used in Business

Under the Federal Code real estate used in a business is treated as a capital asset if a sale results in a gain and as a non-capital asset if the sale results in a loss. The effect of this provision is to give more favorable capital gain treatment to gains of this type, and allow a full deduction for losses (Section 1231, I.R.C.). The State law is different. The definition of capital assets excludes land or depreciable property used in a trade or business (Section 350, Reg. Art. 485(a)). A gain on the sale of real estate used in a business would therefore be fully taxed.

There was another angle in a case submitted by one of our members. The real property which had at one time been used in a business became inadequate and another and larger property was acquired. The former property

was left vacant and offered for sale. After eight months, during which time the property was not used in the business, the property was sold at a profit. Was the gain a capital gain or subject to tax as ordinary income? In our opinion a taxpayer may convert property used in a business to property not used in a business. He may therefore change an asset from a non-capital asset to a capital asset. If that is so, the circumstances in this case would indicate that a capital asset was sold and the gain would be taxable at capital gain rates. There is no doctrine in tax law that once an asset is classified as a non-capital asset, it forever remains as a non-capital asset.

Life Insurance

One of our readers wanted to know if installment payments under a life insurance contract were taxable to any extent. Specifically the facts were that an insured died in 1952 and his widow was the beneficiary of a policy of \$50,000. She elected to receive the proceeds in ten annual installments. Under that option each installment would be \$6,000. Is the \$1,000 taxable as being in the nature of interest?

The proceeds of a life insurance policy received by reason of the death of the insured are excluded from gross income. Prior to the Revenue Act of 1954 the question of what is meant by

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proceeds of a life insurance policy was questioned by taxpayers and litigated in the courts. It was held that proceeds included all installment payments in full. In the case mentioned above the entire amount of \$60,000 would be excluded from gross income. The Revenue Act of 1954 changed this. It now provides (Section 101(d)) that any interest element in the proceeds is included in income, but if the beneficiary is a spouse of the insured there is an exclusion of \$1,000 annually. Under the Code, therefore, no part of the installment is taxable since the insured died prior to August 16, 1954. If the insured had died after that date any amount received in excess of \$6,000 would be subject to tax.

Under the New York law the former Federal rule is still followed and no part of the proceeds is taxable even when paid in installments. Both under the Federal and State laws, if the proceeds of an insurance policy are left with the insurance company under an agreement to pay interest, the interest payments are taxable income to the beneficiary.

Personal Exemption

In a recent tax court case (*Estate of James E. Walsh*, 28 T. C. No. 149) the issue before the court was whether a taxpayer was married on the last day of the taxable year and thus entitled to an exemption for his spouse. A divorce decree had been rendered on December 6, 1952. On December 29, 1952 a motion to vacate the decree was filed. The court was asked to hold that this motion had the effect of reviving the marriage contract. The court held that the taxpayer was not married on the last day of the taxable year and the exemption for the spouse was not allowed.

Under the State law the personal exemption for the year is prorated and the taxpayer would be entitled to an exemption for eleven months on the basis of \$2,500 for the year. That exemption could be divided between husband and wife in any way they determined. If the motion to vacate the decree had the effect of reviving the marriage contract the full exemption of \$2,500 could be taken by husband and wife.

Disallowed Losses—Sales and Purchases of Securities by Husband and Wife

Under Federal law losses resulting from indirect sales between husband and wife are disallowed. This issue came before the tax court in a recent case (*John B. Shethar et al*, 28 T. C. No. 144). Husband and wife each owned securities that had declined in value. By prearrangement, the husband purchased 500 shares of Amerada Petroleum on the stock exchange and the wife purchased 1,500 shares of Canadian Superior Oil over the counter on October 15, 1953. On the following day the husband sold 1,500 shares of Canadian Superior Oil at a loss and the wife sold 500 Amerada Petroleum, also at a loss. Each spouse claimed a deduction for the loss for 1953.

On the authority of the *McWilliams* case (331 U.S. 694), the tax court sustained the Commissioner in disallowing the loss. The fact that the purchases were made before the sales did not make a crucial difference, nor that the wife managed her own property, nor the length of time separating the purchases from the sales.

The State law would be different. Losses on sales between spouses, directly or indirectly, are not disallowed. Nor does the State law disallow losses resulting from so-called wash sales.

Accounting at the SEC

Conducted by LOUIS H. RAPPAPORT, C.P.A.

Some Challenges in Financial Reporting

At annual meetings of the American Institute of Certified Public Accountants, the SEC's Chief Accountant frequently is a speaker. This year's meeting of the Institute at New Orleans was no exception. One of the speakers at the session on October 23, 1957 was Andrew Barr, Chief Accountant of the SEC, whose subject was "Some Challenges in Financial Reporting for Regulatory Agencies." The following is a highlight report of several of the matters discussed by Mr. Barr.

Insurance Company Accounting. Mr. Barr referred to accepted departures from conventional accounting such as in the cases of bankruptcy proceedings and investment trusts (particularly open-end trusts which carry their investment portfolios at market). Conventional accounting followed by insurance companies, he said, also departs from generally accepted accounting and is of great concern to the SEC because of the increase in public offerings of insurance company securities.

The problem as it relates to fire and casualty insurance companies arises out of the lack of correlation between the volume of business done and the net earnings reported. The entire amount of the premium charged to the policy holder must originally be credited to a liability account, "Unearned Premium

Reserve," while the expenses incurred in writing the policy are immediately charged to current income. In a period of increasing premium volume, this method of accounting temporarily penalizes the statutory underwriting results of insurance companies by increasing operating costs. In a period of declining volume, the statutory underwriting results are benefited since the credits to income are based upon the higher volume of business in the past whereas charges to income are based upon the reduced current volume of business. In other words, there is no matching of costs and revenues.

In the prospectuses of insurance companies there is usually printed a tabulation showing the adjustment of statutory net earnings to give effect to the increase or decrease in unearned premium reserve during the years, under report, and a tabulation showing an adjustment of net equity to give effect to the equity in the unearned premium reserve. Mr. Barr stated:

This is not an entirely satisfactory solution to the challenge of obtaining full and fair disclosure for investors in insurance companies. I understand that an Institute committee is considering this problem and may be working toward an adequate solution of reconciling regulation for the protection of policy holders and fair disclosure of financial position and operating results to stockholders.

Accounting and Changing Price Levels. A great deal of thought has been given to the question of historical costs as a basis for accounting and reporting. We have experienced a long period of rising prices which has forced serious study and reexamination of the effect

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of changing price levels on our accounting principles. How, if at all, should this condition be dealt with in the accounts and financial reports?

The Study Group on Business Income in 1952 recommended that the primary statements of income should continue to be made on bases then (and now) commonly accepted. It was suggested, however, that corporations should also furnish supplemental information that will facilitate the determination of income measured in units of equal purchasing power.

Mr. Barr stated that if such material is permitted to be included in the certified statements, the question arises whether the practice should be made a requirement. The Commission has consistently refused to accept financial statements reflecting depreciation based on replacement costs.

Tax Effect Accounting. Mr. Barr was critical of companies that claim immediate tax benefits arising from deductions for liberalized depreciation, but use lower rates of depreciation for corporate reporting purposes. Failure to keep accounting for taxes and reporting purposes on the same basis when the operating facts support uniform treatment may result in seriously misleading financial statements. Several cases have come before the SEC in which accelerated depreciation methods had been claimed for tax purposes whereas straight-line depreciation had been continued on the books with no adjustment for deferred taxes. The improvement in earnings resulting from this practice has been so large in some of these cases that amendment of the statements to include an additional charge equal to the tax benefit has been required on the grounds that failure to do so would make the statements seriously misleading.

Mr. Barr also referred to other major differences between tax accounting and

accounting for corporate reporting purposes, such as the treatment of intangible drilling costs, statutory depletion, installment sales, bad debts and warranties. There are so many such items of material importance, he said, that it may now be deemed of material significance to know whether there are such differences. He continued, "It may well be that a complete reconciliation between taxable income and reported income . . . is now indicated in order to meet the standards of full and fair disclosure."

Independence of Accountants. Mr. Barr referred to the differing requirements of the SEC and the Institute relating to an accountant's financial interest in his client. Under the Commission's rules the accountant is prohibited from having any financial interest in his client or its affiliates. On the other hand, the rules of the AICPA merely require disclosure of a *substantial* interest of the accountant if he renders an opinion on financial statements which are used as a basis of credit and prohibit ownership of a *substantial* interest in an enterprise financed in whole or in part by public distribution of securities.

These two conflicting standards of independence often cause confusion. It has been urged by some accountants that independence is a state of mind . . . and that standards of professional work should not be affected by his financial interest in the registrant. However, the objective tests of independence to which certifying accountants are held by the rules of the Commission have been adopted for the purpose of avoiding both the opportunity for, and the appearance of, bias and prejudice, or the possibility of undue influence on the part of the client.

Referring to the present-day interest in developing services to management, Mr. Barr said that care should be taken to maintain a clear distinction between the giving of advice to management and the making of decisions for management.

Administration of a CPA Practice

Conducted by MAX BLOCK, C.P.A.

Financial Statements as Works of Art and Literature . . .
Take Care With Diazo Reproduced Tax Returns . . .
Relieving the Overburdened Practitioner.

Financial Statements as Works of Art and Literature

When a first-rate artist completes a painting, he looks at the finished product with a justifiable pride of achievement. It is his work, he is proud of it, and he signs his name to it to let the whole world know who the proud artist is. Many "finishing touches" went into the finished product to bring it to the desired state.

Accountants are artists, too. Consider the financial statements in an accountant's report. Each statement has a different style and symmetry. If carefully arranged, it is graceful and rhythmic in form. If neatly typed, margined and spaced, it has good lines. All in all a statement can have eye appeal in addition to its technical qualities. Before an accountant signs his name to a report he, too, should take a final critical look at its appearance and, if he feels that he is proud of his work, only then should he sign it.

Similarly, the great writer is intensely concerned with the quality of his work. Rewriting of words, sentences and even of pages are very common occurrences with the great masters. Their desire for

excellence in the finished product overcomes the natural impulses of complacency and laziness. They cannot countenance sloppiness in style, poor organization, poor language and grammar, and other common literary weaknesses, because these clash with their ideals, and because their name is linked to each work.

Accountants are writers, too. A detailed annual report often contains many pages of narrative material. There the writer has an opportunity to display his literary talents, his style, his grasp of the language, the ability to transmit technical data to laymen so lucidly and logically that they will read it with interest and absorb it correctly. An accountant will not do well in these respects unless he sincerely cares to do so, is conscious of it at all times, and makes a constant endeavor to absorb good language and style as he reads, and to create good language and style as he writes. Consistent care and interest eventually make good writing a natural process and not a slow one.

Take Care With Diazo Reproduced Tax Returns

This warning cannot be repeated too often—do not relax in your vigilance with respect to the quality of diazo reproduced tax returns. The right to submit returns so prepared is a privilege. Any large scale abuse of this very valuable privilege may well result in its revocation.

So—let us continue to be very careful that the reproductions are of good legible quality, and that we comply with the

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requirements as to paper, ink, size, and color. The approaching personal income tax season will be a challenge. Careful preparation as to proper pencils, paper and forms, and firm instructions to staff will help meet it.

The New York State Corporation Tax Bureau has taken a stiff attitude with respect to unacceptable returns and has been sending them back to the taxpayers. The Bureau microfilms the returns it receives and is therefore very sensitive about their legibility and other reproductive qualities. Moreover a return cannot be put through a microfilm machine if it has staples on it or is bound with other than Scotch polyester tape. Bureau employees cannot take the time to remove staples or difficult adhesive bindings prior to microfilming.

Moreover, the Bureau is very firm about the color of the returns. Only white paper may be used for 3 CT forms and canary colored paper for 42 CT forms. The image color on both of these forms must be a good black. Good reproductions are not possible if "stale" sensitized paper is used and if the rate of machine speed is too fast or too slow.

Relieving the Overburdened Practitioner (Series 3)

A senior partner of a prominent New York City firm offers these words of advice to members of firms with staffs of more than fifteen to twenty men:

"Progressively, since the beginning of the second World War, the complexities of business, coupled with an expanding clientele, have placed upon me so many new and mounting responsibilities, that I found it necessary to seek a high caliber assistant in order to enable me to continue my personal contacts and to render the advice and guidance to which the clients had become accustomed and which they regard as an important part of our service. In reorganizing my own activities so that I could obtain the necessary relief from my assistant, I

also gave consideration to the question of the perpetuation of our firm.

"I was careful to select from our staff a man with the requisite personality, training and potential for high level professional service. I have entrusted him with the supervision of all audits for which I am responsible, with the exception of tax work, and with respect to tax matters he acts as a liaison between our Tax Department and me. He works closely with our personnel manager and makes sure that qualified personnel are assigned to particular audits. He seeks my guidance and advice where such need is indicated. Periodically, and always at the close of the fiscal year, prior to a conference with a client, he prepares a memorandum for me setting forth salient features appertaining to such client's affairs. He is usually present at the conferences with clients unless extremely confidential matters are to be discussed.

"As a result of our practice of having a second partner attend conferences with important clients, this partner is in a position to act in my stead when I am away from the office for extended periods of time, for vacations or for other reasons. A closer contact is thereby established between my partner and the client, and with the knowledge of the client's affairs available to him through my assistant, my partner's task of having to take over in my absence, if this should become necessary, is greatly facilitated.

"I have outlined briefly the steps that I took a number of years ago to prevent overburdening myself to such an extent that I would have been unable to service my clients properly, and perhaps have impaired my health, which I am glad to state, after forty years of accountancy practice, is still good and enables me to play 18 holes of golf, though very poorly, and to devote a fair amount of time to professional and community activities."

Payroll Tax Notes

Conducted by SAMUEL S. RESS

Payments for Illness or Disability

A recent Appeal Board decision held that payments to a claimant under an employer's wage continuation plan during an employee's period of disability in addition to benefits payable under an insurance contract pursuant to the Disability Benefits Law, are not remuneration within the meaning of the unemployment insurance law and therefore not taxable to the employer.

In Appeal Board case no. 60,508-57 (September 13, 1957), it was decided that amounts received by an employee during those weeks in which he received supplemental disability benefits from his employer along with the regular disability payments from the insurance company so as to provide the employee with an amount equal to a full week's pay, were not taxable under the unemployment insurance law. Reference was made to section 517.2 (a) of the law, as follows:

"2. Exclusions. Remuneration does not include: (a) The amount of any payment made to, or on behalf of, any employee or any of his dependents under a plan or system established by an employer which makes provision for his employees generally, or for such employees and their dependents, or for a class or classes of such employees and their dependents, including any amount paid by an

employer for insurance or annuities, or into a fund, to provide for any such payment, on account of retirement, or sickness or accidental disability, or medical or hospitalization expenses in connection with sickness or accident disability or death."

Thus, it appears from the foregoing that the moneys received directly from the employer by the claimant during his period of disability due to illness are excluded under the statute from the definition of remuneration and are not taxable wages.

It is interesting to note however that in order to determine whether or not the employee had had twenty weeks of employment during his base period in order to qualify for unemployment insurance benefits, those weeks for which he had received supplemental payments from his employer over and above the regular disability benefits paid by the insurance carrier, were considered "weeks of employment." The Appeal Board pointed out that the statute was not clear on that precise question and based its holding on Regulation 2(g) promulgated by the Industrial Commissioner which reads as follows:

"'Week of employment' includes any statutory week during any part of which an employee is on paid vacation or other paid leave of absence even though no actual work is performed."

In the present case the Appeal Board distinguished its holding from that made in Appeal Board case no. 49,658-55, wherein a claimant had not been credited with "weeks of employment" for the time when the claimant had received disability benefits exclusively from the employer's insurance carrier.

Under the new regulations just promulgated by the Commissioner of Internal

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Revenue, the employer has the option of deducting or not deducting withholding taxes from wages paid to employees during illness to the extent that such sick pay is not subject to Federal income tax. The regulations dealing with collection of income tax at the source on wages cover Internal Revenue Code Sections 3401 through 3404. The regulations on employers' reports have not as yet been issued in final form.

Every employer, whether or not he elects to withhold on the exempt portion, must keep a record showing:

1. The beginning and ending dates of each period of absence from work for which the exempt payments were made, and

2. Sufficient information from which to establish the amount and weekly rate of each payment.

If the employer elects not to withhold income tax from excludable sick pay, his records should also:

1. Separately state the amount of each such payment and the excludable portion thereof, and

2. Contain either a written statement

from the employee specifying whether his absence from work was due to a personal injury or whether such absence was due to sickness, and if the latter, whether he was hospitalized for at least one day during this period; or any other information which the employer believes establishes the employee's right to the exclusion.

All such payments must be included in the amount shown as total wages on form W-2. However an employer who maintains the records specified above may also show excludable sick pay on form W-2 as a separate item in the space adjacent to "Federal Income Tax Withheld, if any." Any amount of sick pay shown in this space should be labeled "Excludable Sick Pay" so as to facilitate the employee's deduction from wages of "Excludable Sick Pay" taken on line 6(b) of form 1040 for the year 1957.

It should be noted that sickness or injury payments under employer wage continuation plans are exempt from both social security (F.I.C.A.) and federal unemployment taxes.

Bulletin No. 23 and Rules of Conduct

Why should the provisions of auditing Statement No. 23 be incorporated as a rule of professional conduct? The answer appears simple. Five years after auditing Statement No. 23 was approved by the profession, a survey indicated that 20% of auditors' reports were not made in accordance with the profession's approved standards of reporting. The period of education of the profession has passed. How long can the profession attempt to explain to lenders, investors, and analysts just what an auditor's opinion means and be countered with facts that 20% of auditors' opinions do not appear to be governed by the profession's standards? Wouldn't we be in a better position if we were able to reply that we, the profession, insist that all members clearly indicate their professional opinion of financial statements and that members who do not comply with this standard are subject to our self-enforcement processes? We would not be saying that all members will have to make proper judgment as to qualifying or disclaiming an opinion; judgment is too personal to enforce. We would be saying, however, that once an auditor has taken a position it will be expected that he make his position clear in his report. As to disclosure that financial statements were prepared without audit, there is no good reason why such disclosure should not be mandatory.

THE MICHIGAN CPA, October 1957

Federal Income Tax Notes

Conducted by RICHARD S. HELSTEIN, C.P.A.

Dividend Credit: Sec. 1.34-2 Held Invalid . . . Timely Warning on Timely Mailing . . . When Income on Stock Options is Realized . . . Form 2106 Revised . . . Head of Household . . . Accumulated Earnings Tax.

Dividend Credit: Sec. 1.34-2 Held Invalid

When the individual tax returns (Form 1040) were issued for 1954, there was considerable confusion as to how the dividend credit was to be figured when, because of an excess of net long-term capital gain over net short-term capital loss, the alternative tax was used.

Under Sec. 34 of the 1954 Code, a credit was allowed against the tax equal to 4% of the dividends received after July 31, 1954. This credit was limited to 4% of the taxable income (2% in the case of taxable years ending on or before December 31, 1954).

However, Schedule J of form 1040 was set up so that the percentage limitation was computed on the lower of

taxable income on page 3 or taxable income after the elimination of net long-term capital gains. Of course, in cases where the alternative tax was used, the latter would be the lesser. In many cases, especially those where the taxpayer's income stemmed principally from dividends and gains on stock transactions, the limitation set forth on form 1040 resulted in reduction of a dividend credit which would not have been reduced if the limitation was computed only on regular taxable income.

Anyone who felt that this was merely a printing error in the form was soon disabused; and in July, 1955, the proposed regulations on Sec. 34 (which were adopted on February 3, 1956) clearly indicated in Sec. 1.34-2 that the form 1040 reflected the Commissioner's interpretation of Sec. 34(b)(2). See also the second sentence of the last paragraph of Regs. Sec. 1.1201-1(b), adopted July 23, 1957.

The validity of the Commissioner's position had not been attacked in the courts until now, despite the very apparent error in his ignoring that Sec. 63, which defines "taxable income," in effect includes capital gains; and Sec. 1201, which sets forth the computation of the alternative tax is based on "taxable income" as defined in Sec. 63, in-

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stead of redefining it for alternative tax purposes.

At long last the Service's position has been challenged and a District Court has held that Reg. Sec. 1.34-2 is invalid in respect of the limitation based upon the alternative tax computation (*Elliot Springs et al. v. U.S.* U.S.D.C. West. Dist. S.C. Rock Hill Div. C.A. 2075, August 5, 1957). Although no mention was made of the invalidity of that portion of Sec. 1.1201-1(b) involved, the omission may well be due to the recent adoption of that section of the regulations. In any case, the latter is merely a reference to Sec. 1.34-2, and if that section is invalid, the reference in Sec. 1.1201-1(b) would be ineffective.

At the present moment it is not known whether an appeal is being taken by the Commissioner. In any event, claims for refund should be filed for any open years for taxpayers who may have been affected; and the situation should be noted in the preparation of current returns.

Timely Warning on Timely Mailing

Section 7502, IRC 1954 provides that timely mailing of claims, statements or other documents (including petitions to the Tax Court) which are required to be filed within a prescribed period or on or before a prescribed date, shall be considered as timely filing of such document. (This does not apply to returns. See NYCPA, Vol. XXVII No. 4, April, 1957, p. 286.)

However, where there is any doubt that the missive will not arrive before the deadline, it is almost imperative that it be mailed via registered mail and the receipt retained as evidence of the date of mailing.

Regulations, Sec. 1.7502-1 puts the burden of proof upon the taxpayer where the postmark date is not legible. Such proof is furnished by a registration record (Sec. 7502(c)).

In a recent case (*Luther A. Madison* 28 TC — No. 154) the stamps on the envelope enclosing a petition to the Tax Court via ordinary mail were cancelled, but no date of cancellation appeared on the envelope. The petition was received by the Tax Court two weeks after expiration of the 90-day period. The Tax Court refused to accept the taxpayer's affidavit of timely mailing, and granted the government's motion to dismiss for lack of jurisdiction.

When Income on Stock Options is Realized

In a much publicized decision in 1956, the Supreme Court, in the case of *Commissioner v. LoBue* (351 U.S. 243) reversed the Tax Court and the Court of Appeals, in holding that any gain realized by a taxpayer from exercising stock options, at a price less than the fair market value of the stock at that time, was taxable compensation.

The facts in the case follow: In January 1945, LoBue was granted an option by his employer to purchase stock, if he was still employed on June 30. In May he gave his promissory note payable in 1947 in the amount of the option purchase price. He was still employed on June 30. He was given another option on January 1, 1946, for which he gave his note. The notes were paid, and LoBue received his shares in May 1946. The option purchase price was less than the market value of the stock at all times.

In its decision the Supreme Court remanded the case to the Tax Court for decision as to when the options were exercised, i.e. at the time that LoBue gave his notes, on June 30 (the governing date of employment), or when the notes were paid.

In a supplemental opinion (28 TC — No. 158) the Tax Court following its decision in *Estate of James S. Ogsbury*

(1957, 28 TC 93) held that the date for determination was the date on which the taxpayer unequivocally signified his intent to exercise the options. Accordingly, it held that the additional compensation on the first option was earned by LoBue in 1945. The Court did not state whether such date was May or June of 1945, since 1945 was outlawed by the statute of limitations, and any gain realized in that year could not be taxed. Of course, the gain realized in 1946 on the second option was taxed as ordinary income in that year.

This is directly opposite to the provisions of Sec. 1.421-6(b)(1) of the proposed regulations, which holds that compensation is realized at the time the property is transferred and full ownership is realized. It should be noted that the *Oggsbury* case is presently on appeal to CA-2.

Form 2106 Revised

Form 2106 is the "Worksheet For Use of Taxpayer Claiming Local Transportation, Travel or Outside Salesmen's Expenses Incurred as an Employee."

Because a footnote on the old form advised taxpayers using the declining-balance method of computing depreciation on an automobile or other vehicle to disregard the salvage value in computing depreciation, many taxpayers had depreciated the cost to below salvage value and even to zero. This is contrary to Sec. 1.167(b)-2 of the Regulations.

The footnote has been revised on the new form to provide that in no event may an asset be depreciated below salvage value (Notice in IRB 1957-37, 29).

Note however that under the "straight-line" method (Sec. 1.167(b)-1 of the Regulations) and the "sum of the years-digits" method (Sec. 1.167(b)-3 of the Regulations) the basis upon which depreciation is to be computed is first to be reduced by the estimated salvage value of the asset.

Head of Household

In order to qualify as Head of Household under Sec. 1.1-2(b) of the Regulations and Sec. 1(b)(2)(A) of the 1954 Code, a taxpayer no longer has to demonstrate the "right to exercise family control." G.C.M. 20921 (1939-1 CB 174) does not apply to the 1954 Code and Regulations under which the principal factor to be considered is "whether the taxpayer contributed more than half of the cost of maintaining the household, which is his home and the principal place of abode of his qualifying dependents." (Rev. Rul. 57-415, IRB 1957-37, 7)

Accumulated Earnings Tax

Taxpayers with a Sec. 102 (IRC 1939) or Sec. 531 (IRC 1954) problem will be interested in the case of an automobile agency (*Breitjeller Sales, Inc.* 28 TC — No. 137). This corporation, organized in 1931, had, through 1948, never paid a dividend, although it had net profits after taxes in every year (some of which were substantial). During all of the years of its existence, the corporation had loans receivable from its sole stockholder. In 1948, its current assets were \$654 thousand; its current liabilities were \$171 thousand; its required reserve under its General Motors franchise was \$163 thousand. Its accumulated earnings and profits were about a half million dollars, of which more than one-half was invested in securities unrelated to the business.

Hopeless? Not at all. The Tax Court reasoned that plans for physical expansion and the possibility that it might reacquire a dealership in adjoining territory was sufficient reason for retaining its earnings. The arithmetical computation by the Tax Court in its footnote (3) is particularly interesting, since in comparing the amount required in the business with the retained earnings, *only the earnings of the years before the Court are taken into account.*

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